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CRE

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REAL ESTATE ISSUES

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CRE

Editor's Council

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About THE COUNSELORS OF REAL ESTATE

The Counselors of Real Estate, established in 1953, is an international group of high profile professionals including members of prominent real estate, financial, legal and accounting firms as well as leaders of government and academia who provide expert, objective advice on complex real property situations and land-related matters.

Membership is selective, extended by invitation only on either a sponsored or self-initiated basis. The CRE Designation (Counselor of Real Estate) is awarded to all members in recognition of superior problem solving ability in various areas of specialization such as litigation support, asset management, valuation, feasibility studies, acquisitions/dispositions and general analysis.

CREs achieve results, acting in key roles in annual transactions and/or real estate decisions worth billions of dollars annually. Over 300 of the Fortune 500 companies retain CREs for advice on real estate holdings and investments. CRE clients include public and private property owners, investors, attorneys, accountants, financial institutions, pension funds and advisors, government institutions, health care facilities, and developers.

ENRICHMENT THROUGH PEER ASSOCIATION, COLLABORATION, EDUCATION & PUBLICATIONS

Knowledge sharing continues as the hallmark of The Counselor organization. Throughout the year, programs provide cutting-edge educational opportunities for CREs including seminars, workshops, technology sessions, and business issues forums that keep members abreast of leading industry trends. Meetings on both the local and national levels also promote interaction between CREs and members from key user groups including those specializing in financial, legal, corporate, and government issues.

CRE members benefit from a wealth of information published in The Counselors' quarterly award-winning journal *Real Estate Issues* which offers decisive reporting on today's changing real estate industry. Recognized leaders contribute critical analyses not otherwise available on important topics such as institutional investment, sports and the community, real estate ethics, tenant representation, break-even analysis, the environment, cap rates/yields, REITs, and capital formation. Members also benefit from the bi-monthly member newsletter, *The Counselor*, and a wide range of books and monographs published by The Counselor organization. A major player in the technological revolution, the CRE regularly accesses the most advanced methodologies, techniques and computer-generated evaluation procedures available.

WHAT IS A COUNSELOR OF REAL ESTATE (CRE)?

A Counselor of Real Estate is a real estate professional whose primary business is providing expert advisory services to clients. Compensation is often on an hourly or total fixed fee basis, although partial or total contingent fee arrangements are sometimes used. Any possibility of actual or perceived conflict of interest is resolved before acceptance of an assignment. In any event, the Counselor places the interests of the client first and foremost in any advice provided, regardless of the method of compensation. CREs have acquired a broad range of experience in the real estate field and possess technical competency in more than one real estate discipline.

The client relies on the Counselor for skilled and objective advice in assessing the client's real estate needs, implying both trust on the part of the client and trustworthiness on the part of the counselor.

Whether sole practitioners, CEOs of consulting firms, or real estate department heads for major corporations, CREs are seriously committed to applying their extensive knowledge and resources to craft real estate solutions of measurable economic value to clients' businesses. CREs assess the real estate situation by gathering the facts behind the issue, thoroughly analyzing the collected data, and then recommending key courses of action that best fit the client's goals and objectives. These real estate professionals honor the confidentiality and fiduciary responsibility of the client-counselor relationship.

The extensive CRE network stays a step ahead of the ever-changing real estate industry by reflecting the diversity of all providers of counseling services. The membership includes industry experts from the corporate, legal, financial, institutional, appraisal, academic, government, Wall Street, management, and brokerage sectors. Once invited into membership, CREs must adhere to a strict Code of Ethics and Standards of Professional Practice.

USERS OF COUNSELING SERVICES

The demand continues to increase for expert counseling services in real estate matters worldwide. Institutions, estates, individuals, corporations, and federal, state and local governments have recognized the necessity and value of a CRE's objectivity in providing advice.

CREs service both domestic and foreign clients. Assignments have been accepted in Africa, Asia, the United Kingdom, the Caribbean, Central and South America, Europe and the Middle East. CREs have been instrumental in assisting the Eastern European Real Property Foundation create and develop private sector, market-oriented real estate institutions in Central and Eastern Europe and the Newly Independent States. As a member of The Counselor organization, CREs have the opportunity to travel and share their expertise with real estate practitioners from several developing countries including Poland, Hungary, Bulgaria, Ukraine, Czech Republic, Slovak Republic, and Russia as they build their real estate businesses and develop standards of professional practice.

Only 1,100 practitioners throughout the world carry the CRE Designation, denoting the highest recognition in the real estate industry. With CRE members averaging 20 years of experience in the real estate industry, individuals, institutions, corporations, or government entities should consider consulting with a CRE to define and solve their complex real estate problems or matters. ■

Editor's Statement

BY HUGH F. KELLY, CRE

COMMUNICATION IS A TWO-WAY STREET: a truism most would instinctively agree with, but one that journal formats like *Real Estate Issues* sometimes ignore. As we enter 2005, it is time to pay a bit more attention to opportunities for idea exchange in our pages.

Phil Cottone, CRE, the Counselors' 2004 Chair, gets us off to a good start with his letter responding to CRE Buzz McCoy's recent resource review. While reading Buzz's comments on *The Myth of Moral Justice* in the *REI* summer issue, Phil made the connection between the shortcomings of the adversarial approach of conventional litigation and the problem-solving opportunities provided by Alternative Dispute Resolution. Phil's letter doesn't just react to Buzz' review; it carries the dialogue a step further.

I'd like to promote more communication of this nature in *Real Estate Issues*. Our readers are not only thoughtful and experienced, but have splendid vantage points from which to view our industry, its trends, and concerns. We will all benefit from brief remarks on current questions. What do you see coming over the horizon that we need to understand better? What changes are occurring in your business that prompt thoughtful consideration? What topics have been introduced in our articles that are worth further reflection—pro or con—and how do they relate to the field of real estate counseling?

Feedback and responses are very much welcome, but so are suggestions of issues to pursue. Over the years, we have had the opportunity to publish many wonderful manuscripts that have come without special prompting. But there are certainly subjects where *REI* should be soliciting thoughtful essays, and prodding research in our most interesting but under-examined specialties.

Not every article needs to be of feature length. The "Insiders Perspectives" columns introduced under the leadership of Richard Marchitelli, CRE provide shorter frameworks for commentary. Perhaps we should think of a reader-based segment aimed directly at provocative "Points to Ponder," a place where CREs and other subscribers can identify subjects worth pursuing that haven't yet gotten the attention they deserve. What do we need to know, and how can we learn it?

Real estate interacts with many, many related disciplines and interest groups. Elements of finance, law, public policy, architecture and planning, ecology, and business management are all pertinent to us. *Real Estate Issues* can and should be the forum where serious, executive-level dialogue occurs on an interdisciplinary basis. One of the greatest strengths of the Counselors of Real Estate organization is that its invited membership spans that array of disciplines. Let's use that resource to open discussion with the leaders in those fields.

No doubt, this is an ambitious agenda. It couldn't be considered by a society of the size of the CREs without the tremendous dedication, enthusiasm, and professionalism of our Editorial Board. Nor could it be envisioned without the terrific talent on CRE's staff, beginning with our President, Mary Walker Fleischmann, and including Gloria Bowman, Director of Marketing and Communications, and Jonathan Laxamana, Communications Manager. It would be impossible to undertake the role of volunteer Editor-in-Chief without the efforts of the entire professional staff in the Chicago headquarters. My thanks to all.

So the basic message of this editor's statement can be summed up in a comment once made to me by my father-in-law: "God gave us two ears and only one mouth. We should listen twice as much as we talk." Over the years and under the leadership of great editors, *Real Estate Issues* has spoken to the industry, offering insight, analysis, and vision from a host of top-flight authors. We intend to continue that tradition in the years ahead. Our challenge is to complement with features where listening to and interacting with our readers and our colleagues in the industry engage, provoke, and respond to our authors.

Please help us along the road. ■

HUGH F. KELLY, CRE
EDITOR IN CHIEF

Letter to the Editor

Philip S. Cottone, CRE, writes in response "The Myth of Moral Justice as reviewed by Buzz McCoy, CRE" in the Summer 2004 issue of Real Estate Issues, *in which McCoy reviews Thane Rosenbaum's book* "The Myth of Moral Justice"*:*

I READ WITH GREAT INTEREST CRE BUZZ MCCOY'S BOOK REVIEW of *The Myth of Moral Justice* by Thane Rosenbaum, in the summer issue. The review was in Buzz's usual crisp and well written style, and in one insightful sentence he summarizes the theme, that "the justice system undermines truth, perpetuates secrets and lies, prevents victims from telling their stories, promotes adversarial enmity over community repair, and fails to equate legal duty with moral responsibility." Wow, what an indictment. While I would not personally go that far in criticizing what our legal system has become, it surely gives the reader some understanding of why American industry is increasingly embracing ADR, alternative dispute resolution. It is because ADR includes processes, like arbitration and mediation, that are faster, cheaper, more user friendly, and more responsive to the needs of the parties than a traditional courtroom experience. And it gives CREs an appreciation of why we are working to bring those alternatives to the real estate industry through the ADR program The Counselors started a few years ago.

ADR addresses most of the issues raised by Mr. Thane, as reported by Buzz. The review notes, "the law misses the emotional back-story, the suppressed part of every lawsuit. It relies too much on logic and not enough on compassion…It thrives on an adversarial process that only takes prisoners and leaves little room for peace." These are all matters which are addressed by a good mediator, who usually works as a neutral facilitator to find out the emotional underpinning to a controversy, permits the parties to vent and express their feelings, and requires the lawyers to check their guns at the door and leave their adversarial maneuvering for the courtroom. The mediator helps the parties craft a solution that meets their needs and often involves more than money, while, as Buzz notes, "Courts pick winners and losers in a zero sum game that fails to resolve emotional distress."

Arbitration, while similar in some respects to a courtroom in that a tribunal or individual arbitrator makes a binding decision based upon the evidence presented, is somewhat more informal than court, and eliminates some of the legal posturing by restricting or eliminating depositions and motions and relaxing the rules of evidence. The arbitrators are bound to follow the law but also, in most cases, to apply equitable principles as well, while, Buzz notes, the author says in a courtroom, "Many view the law as logical, technical, narrow, bureaucratic and insensitive to basic human emotions and moral principles…"

CREs owe it to their clients to provide pre-dispute ADR clauses in their real estate contracts to make sure any disputes regarding the agreement end up in the CRE ADR program, not a courtroom. That will make sure clients avoid the litany of horrors noted by the author, as recounted by our faithful reviewer, Buzz McCoy, CRE.

PHILIP S. COTTONE, CRE
PROPERTY TRUST ADVISORY CORPORATION
DEVON, PA.

EDITOR'S NOTE

For more information about CRE Alternative Dispute Resolution, please visit:
http://www.cre.org/programsandservices/adr.cfm

Real Estate in the Investment Portfolio

BY ROY T. BLACK, PH.D., J.D

1. HISTORY OF MODERN PORTFOLIO THEORY

Modern portfolio theory (MPT) began in 1952 with the publication of an important article by Harry Markowitz. Markowitz was the first researcher to prove the old adage "Don't put all your eggs in one basket." Essentially, he proved mathematically that by diversifying investments, the investor can lower the risk of the investment portfolio, or conversely, earn a higher return for the same amount of risk as an undiversified portfolio. Perhaps more important than proving the common sense adage, Markowitz gave us the tool by which we could measure the benefits of diversification. Put simply, the objective of the investor is either to minimize portfolio risk subject to a target rate of return or to maximize the return on the portfolio subject to a target level of risk. To do this, the investor uses mean-variance portfolio analysis. This analysis can tell us how many eggs to put into which basket.

All investments have some degree of risk. We accept U.S. government securities, such as T-bills, as being risk-free because they are backed by the full faith and credit of the U.S. government. They have the lowest amount of risk, but also a very low return. Government securities illustrate the fact that investors expect to be compensated for taking risk. The higher the risk, the higher the investor's expected return. One generally accepted measure of risk is the variance of returns, measured by standard deviation. Standard deviation in this context is the amount by which returns vary over time around the average return. By way of simple example, if two investments both had a 10 percent return over a three-year period, but Investment A had annual returns of 2 percent, 18 percent, and 10 percent, and Investment B had returns of 8 percent, 10 percent, and 12 percent, then Investment A had a higher variance of returns. All other things being equal, a prudent investor would prefer Investment B because it had a lower risk. The higher the volatility of the investment, the more likely the investor might have to sell at a time when the investment was at a low ebb.

So how does MPT deal with lowering risk? The answer is simple in its elegance. Let's assume that there are two different investments, A and B, both returning 10 percent over time. They are both volatile with high standard deviations of returns. However, whenever Investment A goes up by one dollar, Investment B goes down by one dollar. Conversely, whenever Investment B goes up by one dollar, Investment A goes down by one dollar. These two investments would be said to be perfectly negatively correlated; that is, their covariance is -1. A positive change in one investment of one dollar is perfectly matched by a negative change in the other. The variance of each asset cancels out the other, and in this hypothetical case, the investor earns a 10 percent return with no variance in the return over time. This is one of the most important concepts of MPT: that it is not the variance of return of an investment that matters, it is the covariance of returns of that investment

About the Author

Dr. Roy T. Black is GSU Real Estate Alumni Professor in the Department of Real Estate at the J. Mack Robinson College of Business at Georgia State University. He teaches courses in real estate finance and investments, land use regulation, and international real estate. Prior to joining the faculty at Georgia State, he practiced law with the firm of Black and Black, P.C., and was president of Investors Brokerage Company.

with other investments that matters. It is virtually impossible to find investments that are perfectly negatively correlated. However, investments can be found that have negative correlations less than -1, say, -0.5. Since any negatively correlated asset lowers the variance of returns of the portfolio, it provides some portfolio benefits. Even an asset with a low positive correlation provides some benefits, although not as much as a negative correlation.

The variance of returns of an individual asset is known as nonsystematic risk (or idiosyncratic risk). Markowitz proved that if you combine approximately 30 stocks in a portfolio, the variance of the stocks cancels out and most nonsystematic risk is eliminated. What the investor cannot eliminate by choosing several stocks is systematic risk, the general risk of the marketplace. No matter how many stocks the investor picks, she cannot eliminate the risk of the stock market. The risk of any market can be proxied by an index consisting of either all or a representative sample of the investments in that market. We are fortunate to have stocks traded on organized exchanges that have publicly reported daily (actually instantaneous) prices and publicly available information on dividends. The Standard & Poor's 500 is an example of such an index. From the daily returns of a stock we can calculate its covariance with other stocks. This means that rather than selecting stocks at random (naive diversification), we can seek stocks that display patterns of historic covariance and hope that the covariance continues in the future.

But what happens when we have achieved efficient diversification in the stock market? We have diversified away as much nonsystematic risk as we can in stocks. Can we go any further? The answer is yes, if we add an asset class to the portfolio that is negatively- or low positively-correlated with stocks.

2. WHY ADD REAL ESTATE TO A MIXED-ASSET PORTFOLIO?

The purpose of this paper is to examine the role of real estate in a mixed-asset portfolio. Real estate, both public and private, has a place in a portfolio of stocks and bonds, and this paper reviews evidence illustrating the benefits of including real estate.

As used in this report, the term “publicly traded REIT” means a real estate investment trust stock that is traded on a public exchange, such as the New York Stock Exchange. “Private” or “Direct” real estate refers to an investment in a building, or in a nonpublicly traded investment such as a nonpublicly traded REIT, limited partnership, or other form of private syndication.

Geltner and Miller estimate that total investments in the United States, public and private, debt and equity, were $40 trillion as of the late 1990s. Real estate represents more than one-third of this investable capital in the United States, with stocks, bonds, and private debt comprising the other two-thirds.[1] To understand the benefits of adding real estate to a portfolio of stocks and bonds, we apply Modern Portfolio Theory. To do so, we must know the return and risk or volatility. Thus, it would be helpful to have an index for real estate similar to the S&P 500 for stocks. Research by Liang and Webb,[2] Firstenberg, Ross and Zisler,[3] Giliberto,[4] Geltner,[5] and Geltner[6] has shown that to analyze real estate as an asset class, we must have an appropriate index to be able to compare it with other asset classes.

3. THE NCREIF INDEX

The National Council of Real Estate Investment Fiduciaries (NCREIF), along with the Frank Russell Company, started the NCREIF Property Index (NPI) in the late 1970s. This data series began in the first quarter of 1978. The Index represents a value-weighted aggregate of private U.S. real estate properties reported with no mortgages. The index is broken down into subindexes of apartment, hotel, industrial, office, and retail properties. There also are regional subindexes for the East, Midwest, South, and West. As of the first quarter of 2004, the NPI had a value of over $136 billion. NCREIF members contribute data to the Index, which is updated quarterly. The NPI is the most widely cited performance measure for the market in direct real estate investments. Members contribute quarterly data on the income from each property, and the price of each building upon acquisition and sale. Because all properties do not sell each quarter, properties that have not been sold are appraised. The NPI thus computes the returns to real estate based upon net income from operations and any price increases (or decreases) measured by sales prices or appraisals.

There are problems with the NPI. One is the fact that it is only updated every quarter. Thus, we only know the volatility on a quarterly basis. It would be great if we could have it on a monthly or even weekly basis. However, considering the massive amount of data to be reported, and the difficulties of providing quarterly appraisals on every unsold building, the NPI is a phenomenal achievement. Also, some scholars feel that using appraised values as a part of the index understates the volatility of the asset prices. Further, the Index only contains investment-grade properties and might not be representative of small, local commercial buildings. Nevertheless, the NPI is the best national index we have that tracks the returns in direct real estate investments. Since the data are considered accurate and reliable, the NPI is generally considered to be a valuable proxy for investment-grade real estate returns. NCREIF is constantly working on improving the index, and its value as a benchmark of real estate returns is likely to increase in the future as better and faster data reporting methods are instituted.

4. WHAT ABOUT PUBLICLY TRADED REITS VS. PRIVATE REAL ESTATE INVESTMENTS?

If publicly traded real estate investment trusts were a perfect proxy for investing in real estate, this report would stop at this point. Many REITs are publicly traded, and thus we have the same information about them as we do for the stock market as a whole. Important studies by Ling and Naranjo[7] found that publicly traded REITs behave differently than private investment real estate with regard to covariance and risk factors. Specifically, publicly traded REITs are more volatile and move more with the stock market than private real estate. Thus, publicly traded REITs will provide less portfolio benefits than private real estate. Publicly traded REITs will move more closely with the S&P 500 than will private real estate investments. Simply, private real estate has better covariance with the stock market, helping to smooth the volatility of a mixed asset portfolio better than publicly traded REITs. These findings were backed up by other studies.[8]

The index for publicly traded real estate investment trusts is the NAREIT Index, published by the National Association of Real Estate Investment Trusts, which is based on share prices and dividends of all publicly traded REITs. The NAREIT ALL REIT Index tracks REIT stocks trading on the New York Stock Exchange, the NASDAQ National Market System, and the American Stock Exchange since 1972. One study computed correlation coefficients between the NAREIT Index and the Russell 2000 Index (an index of small capitalization stocks), between the S&P 500 Index and the NCREIF Index, and between the NAREIT and NCREIF Index during the period 1979-1993.[9] The researchers found a high positive correlation (.722) between the NAREIT Index and the S&P 500, suggesting that publicly traded REITs do not provide much help in diversifying a stock portfolio. The correlation between the NAREIT Index and the Russell 2000 was even higher (.779). By comparison, there was a very low correlation between the NCREIF Index and the S&P 500 (.0523). The correlation between the NAREIT and NCREIF Index was also very low (.0276), indicating no relationship between direct investments in real estate and investments in publicly traded REITs. The conclusion to be drawn from this study is that adding publicly traded REITs to a portfolio of stocks provides little help in the way of portfolio benefits. Adding direct or nonpublicly traded investments in real estate does provide a significant level of portfolio benefits. However, this study did not include more recent years, and did not consider the effect of adding both private and publicly traded real estate to the portfolio.

This does not mean that publicly traded REITs have no place in a mixed asset portfolio. Publicly traded REITs can provide attractive returns. Mueller and Mueller found that over a 25-year period, publicly traded equity REITs had an average annual return of 14.45%, better than the 14.24% over the same period for the S&P 500.[10] In addition, the returns for publicly traded REITs have a lower risk for the reward than the stock market as a whole. A widely accepted measure of risk-adjusted return is the Sharpe Ratio which is a fraction, the numerator of which is the risk premium (the compensation to an investor for investing in an asset that has risk) and the denominator of which is risk (defined by volatility, or standard deviation of returns). A recent report by Global Real Analytics LLC concluded that over the past 25 years, publicly traded REIT stocks have the lowest risk for the biggest reward when compared to the S&P 500 and Treasury Bonds.[11]

Most of the early research found that publicly traded REITs move with the stock market more than with the direct real estate market and are best thought of as being closer in the small cap stock category. However, there is some evidence that the NAREIT Index is drifting to a lower correlation with the S&P 500 Index, but less dramatic declines were measured with other stock indices such as the Russell 3000 and 2000 Value and Growth Indices.[12] This means that there is some indication that publicly traded REITs will provide slightly better diversification benefits than was believed in the past, relative to stocks. The Mueller and Mueller study[13] finds only a moderately high correlation of 0.55 over a 25-year period (quarterly) between publicly traded equity REITs and the S&P 500. As might be expected, the NCREIF Index over the same period had a low -0.03 correlation with the S&P 500, lending weight to the previous studies. Until recently, the research focused on the ability to improve a mixed-asset portfolio's efficiency by adding either publicly traded or private real estate but not both. Mueller and Mueller carried the analysis further by examining the inclusion of both publicly traded and private real estate. They found almost no correlation between the NAREIT Index and the NCREIF Index. This indicates that a mixed-asset portfolio could benefit from including both direct real estate and publicly traded REITs. They hypothesize that the lack of correlation may be due to the fact that during the 25-year time period of the study, the NAREIT Index consisted largely of retail and multifamily properties, while the NCREIF Index was mainly office, industrial, and retail properties. By testing different combinations of assets in portfolios, the authors found that the inclusion of both public and private real estate was more efficient than just including one or the other or neither. They found also that direct real estate (NCREIF) was more efficient for portfolios with lower risk and return, and publicly traded REITs were more efficient for portfolios with higher levels of risk and return. The implication is that a conservative investor benefits from adding both types of real estate to his portfolio, but is better off with a higher proportion of direct real estate. An investor who is willing to take on more risk also benefits from having both types of real estate in the portfolio, but benefits from a higher proportion of publicly traded REITs.

There could be more changes in the future, as the past is not always a good predictor of the future. If an investor seeks to create an efficiently diversified portfolio, publicly traded REITs will not provide the same diversification benefits (lowering the standard deviation of returns) as direct or nonpublicly traded investment vehicles, although a combination of both may provide the maximum efficiency. However, publicly traded REITs do provide some diversification benefits, since recent research refutes the earlier research and shows a lower correlation between the NAREIT Index and the S&P 500 Index.

Why are publicly traded REITs different from private investments? Since REITs are limited by law to predominantly real estate investments, and the law further requires REITs to pay 90 percent or more of its available cash flow to investors, conventional wisdom would suggest that REITs should be close to a perfect proxy for direct or non-publicly traded real estate investments. However, there is one major difference between publicly traded REITs and private real estate: liquidity. Publicly traded REIT shares can be sold daily, whereas private real estate investments cannot. Information about rents and trends in real estate can be rapidly incorporated into the share prices of publicly traded REITs. These rapid fluctuations may account for the fact that publicly traded REITs exhibit a higher volatility than direct real estate. This liquidity also means that funds can flow freely and rapidly into the market for publicly traded REIT shares. One study shows that capital flows into REITs are positively related to prior returns, suggesting that publicly traded REIT investors may follow momentum trading strategies.[14] Whatever the reason, the relatively high correlation of the NAREIT Index and the S&P 500 Index means that investors cannot use publicly traded REITs as a proxy for direct real estate.

Recent research by Clayton and MacKinnon shows that while public and private real estate are still separate and distinct markets, there is a trend for publicly traded REITs to behave more like direct real estate and less like stocks.[15] This study shows the increased sophistication of recent research to look at smaller time periods to examine varying factors. The authors also distinguish between small cap REITs, which are "more like real estate," and large cap REITs that continued to display a stronger correlation with the stock market. This research into market segmentation means that we know more about publicly traded REITs and can use them more effectively as investment vehicles.

5. HOW MUCH REAL ESTATE SHOULD AN INVESTOR PLACE IN A MIXED ASSET PORTFOLIO?

Several researchers have looked at the question of how much real estate should be placed in a mixed-asset portfolio. Most of the research constructs a portfolio consisting of stocks, bonds, and either publicly traded equity REITs or private real estate (or both forms of real estate). The most comprehensive research articles calculate the "efficient frontier"—a set of all possible efficient portfolios. When this set is graphed with one axis of the graph representing return and the other representing risk, it forms a line with each point on the line being the maximum return for each level of risk for each portfolio. Using the calculation for the efficient frontier, an investor could combine different assets into a portfolio and choose the most efficient portfolio for any given level of risk or return. Thus, the amount of real estate in any mixed asset portfolio (and the balance between public and private real estate) will change for any portfolio along the efficient frontier. One early study by Fogler used Markowitz mean-variance analysis and concluded a minimum direct real estate commitment of 15% to 20% of the total portfolio.[16] More recently, Mueller and Mueller calculate the efficient frontier for a mixed portfolio of stocks, bonds, and real estate over a 25-year period. At the lowest level of risk and returns, the portfolios are dominated by bonds. The authors calculate all efficient combinations of assets. Including private real estate (NCREIF Index) decreases the volatility of a Markowitz efficient portfolio for the lower half of the efficient frontier. Including publicly traded REITs provides improvement over the entire efficient frontier, but provides the most benefits in the upper half of the efficient frontier.[17] The theoretical allocations to real estate exceed 50% of the portfolio. The previously-cited study by Global Analytics LLC constructs an "ideal" portfolio consisting of 46% publicly traded REIT shares, 32% dedicated to an S&P 500 Index fund, and 22% devoted to bonds.[18]

In summary, private real estate has a stabilizing effect on a portfolio of stocks because it does not fluctuate with the stock market as much as publicly traded REITs. Publicly traded REITs do not provide as much stability but add higher returns and volatility toward the top part of the efficient frontier (higher risk, higher return portfolios).

Other studies reach differing conclusions, probably depending upon the time period and indexes used, but a general consensus would place the allocation to real estate in the 20% range. This number would vary depending upon the individual investor's risk/return preferences, and also the balance between publicly traded and private real estate would vary. The main point is that the allocations to real estate from calculations of the efficient frontier exceed the normal allocations in the average portfolio. Theory and research support higher allocations.

6. WHAT ARE THE IMPLICATIONS FOR THE INVESTOR?

This paper is not an exhaustive review of portfolio theory, the role of real estate, and the distinction between publicly and privately traded real estate. Rather, it is an attempt to provide a perspective on real estate that provides information for financial professionals who want to know more about the benefits of adding real estate to a mixed portfolio of investments. There are many studies that come to differing conclusions depending upon the time period studied, the research methodology used, and the database under analysis. However, there are some conclusions that can be reached about adding real estate to a mixed investment portfolio:

- Adding real estate improves the efficiency of the portfolio, giving either a higher return for the same amount of risk or a lower risk for the same return.

- Studies have found private, or nonpublicly traded real estate, provides more efficiency in terms of portfolio benefits because of covariance benefits and lower volatility compared to other asset classes. It provides stability to a portfolio of stocks and bonds by decreasing the volatility of returns.

- Publicly traded REITs have a place in the mixed-asset portfolio and, when used in combination with private real estate, may provide additional benefits, perhaps the maximum portfolio efficiency. Publicly traded REITs are beneficial to the investor in the upper part of the efficient frontier (higher risk, higher return portfolios) and such portfolios are better off with publicly traded REITs than without them.

- Some recent research is suggesting that publicly traded REITs are beginning to show a tendency to act "more like real estate," which could show additional benefits as further research is completed. If further research shows this trend continuing, publicly traded REITs could become even more attractive in a mixed-asset portfolio. A continuing tendency toward favorable covariance with stocks and bonds would be very beneficial.

- Both private real estate and publicly traded REITs add efficiency to a mixed-asset portfolio. Studies continue to show that direct real estate is more efficient when added to a portfolio that has a lower risk/return profile, while publicly traded REITs are more efficient when added to a portfolio that has a higher risk/return profile. Either way, research shows that both public and private real estate is underrepresented in most mixed-asset portfolios. Investors could benefit by structuring portfolios with real estate to meet their risk/return preferences.

■ The relatively high correlation of the NAREIT Index and the S&P 500 Index means that investors cannot use publicly traded REITs as a proxy for direct real estate.

Some caveats should be mentioned. First, obviously the selection of individual investments and their qualities can vary, and merely adding real estate to a portfolio is no guarantee of improved performance. Second, while we can reach general conclusions about the value of adding real estate to a mixed-asset portfolio, it should be obvious that real estate research is a moving target and the conclusions of the future may be different from those today. Particularly with publicly traded REITs, the research has shown different conclusions based on the size of the REIT, the time period under study, and the weighting of property types. Nevertheless, there is a strong argument to be made for adding real estate to a portfolio. Using MPT, a disciplined investor can take advantage of what is known about this asset to construct a balanced, efficient portfolio that should outperform in the long term most investors who chase yields and follow the investing fads of the day. ■

AUTHOR'S NOTE

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ENDNOTES

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The ABC's of Asset Management

BY I. HENRY GLICKMAN, J.D., C.C.I.M.

WHAT IS ASSET MANAGEMENT?

ASSET MANAGEMENT CAN BE DEFINED as *the process of overseeing property performance with the goal of enhancing value and maximizing return to the owner*. Asset management does not consist of a single activity that takes place at a discrete moment in time. It takes place over the life cycle of a property (from acquisition to disposition). It is **a process**. Asset Management is about maintaining and creating value consistent with ownership objectives. It blends both a "big picture perspective" and a "hands-on" approach to day-to-day operational issues *and* decision-making. This is done through an *efficient balance* of landlord/tenant relations, budgeting, operating expense analysis and control, real estate tax and insurance reviews, capital improvements, energy management programs, lease analysis and market awareness. Based on these various factors, Asset Managers determine ways to increase the profitability of the various properties under their stewardship.

The Asset Manager's functions will also vary depending on the size of the owner's property holdings. However, in all cases, Asset Managers take on the role of CEO of their respective portfolios. Each property is in reality a business unto itself, and heading up the conglomerate which those businesses form is the Asset Manager. Envision an orchestra. At the conductor's podium is the Asset Manager, setting strategy and monitoring property performance in concurrence with the owner's objectives. In order to effectively execute their function, Asset Managers must be like true entrepreneurs, coordinating the activities of a broad range of disciplines which compose the various musical groups of the orchestra. Sitting in the seat of first violin is the Property Manager. Next is the Leasing Agent. The other sections of the orchestra consist of:

- Environmental Health and Safety Consultants (who deal with issues such as radon, mold, asbestos & underground storage tanks)
- Property Tax Specialists (see also "Attorneys" below)
- Construction Managers (who are called in to consult on issues such as structural problems, leaks, settling and to perform due diligence on new properties)
- Attorneys (who get involved with rent collection from deadbeat tenants, leasing, and various property liability matters, i.e. slips and falls)
- Architects
- Security Consultants
- Energy Consultants (who inspect equipment and make recommendations on how to make properties run more efficiently
- Appraisers (who help develop and confirm market value for the properties)

About the Author

I. Henry Glickman, J.D., C.C.I.M., has written extensively in the fields of corporate real estate, property management and land use. In addition, he is on the faculty at the Steven L. Newman Real Estate Institute, City University of New York and is a member of BOMA's Asset Management Roundtable.

Drawing upon the input of these specialists, the Asset Manager analyzes a given situation and makes recommendations to ownership in accordance with market trends and conditions.

To avoid confusion, it's necessary to clarify the difference between the role of the Property Manager and that of the Asset Manager. The Property Manager monitors the on-site staff at a building to make sure that the operational objectives for the property as set out in the strategic plan which the Asset Manager puts together are being carried out. The Property Manager is the primary point-of-contact with respect to tenant relations. Property Managers are responsible for facility staffing, bill payment, rent collection, lease administration, building maintenance and execution of work orders. They are also responsible for purchasing supplies and achieving competitive pricing on goods & services used at the building. Additional duties may include approving service contracts (elevator, rubbish removal, cleaning) and preparing a first-cut annual budget.

Asset Managers take a more global approach, recognizing that the properties in their portfolio represent a significant investment and it is their responsibility to create a plan for each property which establishes realistic performance goals. Their role is to select and hire Property Managers, consultants and brokers who will work with him/her to enhance the competitive position of a project by ensuring that each property is leased, marketed, staffed and maintained. They closely monitor the financial performance of their portfolio and possess an "internal audit mentality," checking to see that leases are billed correctly and that expenses are both justified and kept in check.

Asset Managers are charged with building value during a property's holding period, analyzing and making recommendations regarding their portfolio in accordance with market trends and conditions. In short, the Asset Manager oversees the operation of the properties in their portfolio *as if they were their own*.

Originally, many Asset Managers were hired as employees by financial institutions and were charged with "cleaning up" their disaster-laden portfolios caused by both overbuilding and greed. Their principal focus was to analyze the market and make recommendations as to major capital improvements, lease negotiations, and changes in use (if viable) in order to ultimately transform these properties from non-productive to productive assets. Eventually, this business was supplemented by private consultants. As the bulk of these properties was eventually turned around, owners began to realize that there was a need, going forward, for someone to act as the owners' eyes and ears on a macro level, apart from the day-to-day role of the Property Manager. As a result, both small and large owner/investors started hiring Asset Managers to examine, evaluate and implement programs to maximize their real estate portfolios and to aid in decision-making regarding potential acquisitions and dispositions. In performing these various functions, the Asset Manager essentially wears two hats-both a financial and a non-financial one. Let's turn first to the financial side.

BUDGETING & FORECASTING

The Asset Manager's bible is the budget. This document, which reflects the Asset Manager's—and by extension, the owner's—best guess as to the timing and magnitude of income and expenditures associated with the property during the year, is used as a yardstick against which actual progress is measured. Since the Asset Manager is the primary decision-maker with regard to maintaining a property's profitability, the budget serves as a basic tool in this regard. Typically compiled 3-4 months prior to the start of each fiscal year, a first generation document is usually prepared by the individual Property Manager. The assumptions used by the Property Manager are then tested and refined by the Asset Manager through a series of iterations. By adequately anticipating expenses, a budget helps to project a calamity before it happens.

In terms of structure, the budget consists primarily of two elements:

1. Operating Budget, with a so-called "Top Line" (consisting of current revenue), a "Middle Line" (consisting of current expenses) , and a "Bottom Line" which reflects the net income resulting from the day-to-day operations of a property; and

2. Capital Budget, (consisting of large dollar expenditures which extend the property's life or productivity and are depreciated over time).

When both the Operating and Capital Budgets are combined, they yield the resulting cash flow generated by the property.

When all current expenses for a property are added together and then subtracted from current revenue, the result yields Net Operating Income ("NOI"). The concept of NOI is one of the most important terms in the Asset Manager's vocabulary. It is the determinant of real estate profitability unrelated to the level of debt which the owner took on to purchase the property and ultimately is the source for establishing its value. If the Asset Manager's job could be boiled down to one simple mantra, it would be this: "Increase NOI."

FINANCIAL REPORTING

In addition to overseeing the budget process, the Asset Manager is involved in periodically reviewing a number of additional reports in order to assess the property's financial well-being and take corrective measures where warranted.

Foremost among these is the monthly Variance Report, which compares budgeted to actual income and expense.

Typically, only variances in excess of a 5% differential from the budget are tracked and explained. By doing so, the Asset Manager is able to better understand, analyze and control the cause of unexpected deviations from the budget, both in terms of timing and amount. Based on this information, Asset Managers can then refine their forecasts, especially with regard to projected cash flow, and revisit current year goals and objectives as well as incorporate these changes into subsequent year budgets.

In conducting monthly reviews of a property's operational and financial performance against plan (i.e. budgetary parameters), the Asset Manager will also want to look at a number of additional reports. These include:

- Rent Roll
- Aged Receivables
- Vacancies
- Profit & Loss (P&L)
- Accumulated NOI
- Cash Account
- Security Deposits
- Balance Sheet
- Check Register
- General Ledger
- Payroll
- Current Payables
- Escrows
- Accumulated Depreciation
- Tenant Retail Sales
- Taxable Income Projection

Other items usually tracked are leasing and marketing activities, pending litigation, move-ins and move-outs and major construction and maintenance projects.

Since it can take several days to compile these reports after the end of the monthly accounting cycle, the Asset Manager will typically not be in a position to review this information until the first or second week of the following month. Based on the Asset Manager's careful analysis, a written report may be prepared for ownership, summarizing their contents, pointing out any implications going forward, and making recommendations for future action as required.

BUSINESS PLAN

With the overall objective to maximize value, the Asset Manager's role can be seen consisting of three main steps:

1. Analyzing the portfolio
2. Formulating a strategy to increase cash flow
3. Implementation.

To guide this process, the Asset Manager will prepare a blueprint or business plan for each property which s/he will monitor and update on a quarterly basis. The plan will include a mix of financial, marketing and operating strategies which the Asset Manager will develop based on each property's specific situation. It should reflect both the owner's investment objectives as well as the realities of the local economic environment. For overseas investors, this information is especially important as the Asset manager is relied on to be ownership's eyes and ears, providing sound advice based on accurate and current knowledge.

In essence, the business plan should address a property's capacity to generate NOI and outline the steps to be taken to resolve any related issues. Generally, the following elements should be included:

- Property Description
- Historical Background
- Loan Information (if any)
- Legal Issues
- Management Operational Review
- Physical Operational Overview
- Market Competition Survey (e.g. challenges & opportunities)
- Leasing Issues
- Marketing Plan

The business plan may also identify several possible alternatives for ownership's consideration along with the financial feasibility of each. These may include maintaining the status quo, undertaking a remodeling, refinancing an existing above-market rate, relaxing/tightening credit standards for tenants, shortening or lengthening lease terms, changing a property's use or liquidating the property altogether.

TROUBLED ASSETS

In extreme situations, Asset Managers may find themselves working with what can be generally described as troubled assets. These properties may be sound assets in weak markets, assets that underperform relative to the market or both. Since the distressed nature of such properties affects their value, the Asset Manager must minimize or eliminate the problems which detract from their potential and characterize them as "troubled." Many times, these assets are on the balance sheets of financial institutions, which take them back as a result of borrower default. Properties acquired in this fashion are known as Other Real Estate Owned ("OREO"). In such cases, ownership's primary objective is to either convert them from non-performing to performing assets or to liquidate.

Upon acquisition of an OREO property, it is recommended that the Asset Manager undertake the following steps:

1. Secure the property
2. Insure the property with hazard and liability coverage
3. Activate/change utilities to name of new owner
4. Check mechanical systems
5. Check for environmental problems (mold, asbestos, radon)
6. Prioritize damage repair schedule
7. Repair physical deficiencies

From there, the Asset Manager will be closely involved in decisions regarding the property's future status. These include whether improvements are warranted at additional cost, whether there will be a buyer for the building in its current condition and if so, what is an appropriate price. Some properties, when taken back, are still unfinished and the issue for the lender then is whether it should hold the asset until completion.

In formulating a strategy, the Asset Manager will want to consult with a host of individuals such as property managers, brokers, appraisers, contractors and potential buyers to solicit their opinions. In some cases, the decision will be made to stabilize the property, usually defined as 95% occupancy, before a sale is made. In other cases, the institution holding the property will want to avoid any continuing liability, such as maintenance and repair and taxes, and will be willing to sell at a discount. Where an "as-is" sale is contemplated, an allowance will usually be given for any deferred maintenance such as HVAC repairs, broken windows or a leaky roof. Other techniques used to incentivize the marketplace include increasing brokerage commissions, guaranteeing existing leaseholds and paying the buyer's closing costs (i.e., title insurance, legal fees and transfer taxes). Usually, a lender will prefer an all cash sale to minimize its risk of tying up the property while buyer financing is sought. Understandably, lenders are reluctant to make new loans to new borrowers on properties which have already been the subject of failed loans. However, sometimes the only way to sell a troubled asset is if the seller takes back paper.

REPOSITIONING

Where a strong case can be made for eventually recapturing additional investment based on expected returns, the Asset Manager will want to devise a repositioning strategy. Properly executed, such a strategy can overcome negative perceptions associated with a property due to poor location, difficult layout, obsolete infrastructure or unattractive spaces. Ultimately, the program's objective is to increase market share and secure additional tenancy.

Before embarking on such a program, it's a good idea for the Asset Manager to identify those property characteristics, such as unique architectural features, that may be used to help reposition the asset. Oftentimes, these can suggest a name change which, in itself, will serve to burnish the property's image.

A repositioning itself can be cosmetic as well as structural. Typical elements can include interior and exterior painting, lighting, landscaping and parking lot re-striping. These can be combined with a major redesign where walls are moved out, storefronts projected and windows and skylights added. Alternative opportunities exist where unfinished basements, attics or large public spaces are reconfigured to recapture additional leasable area. Retail space with poor visibility can be converted to office. Large stores can be subdivided into smaller ones or L-shaped configurations created; since smaller spaces usually rent for more per square foot than larger spaces, additional visibility can be opened up to allow for smaller tenants. Other common projects include lobby renovations, mall kiosks, restroom upgrades and elevator cab replacements. While not as conspicuous, the addition of an energy management system or updated HVAC plant can serve to reduce operating costs, thereby also adding to NOI.

The phenomenon of converting existing uses to more economically productive ones is known as "adaptive reuse." In many instances, a property's former use is no longer viable due to technological or social change. In those cases, the Asset Manager, paired with the ingenuity of a creative architect, can maximize property value by capitalizing on current market trends and local need. Examples of such adaptive reuse abound, from factory loft conversion to apartments or warehouse conversion to office space. Other such opportunities include apartments becoming dormitories, hotel rooms or assisted living units. Large spaces, formerly anchoring now defunct strip centers, have been turned into auto showrooms, skating rinks, health clubs and movie theatres, while smaller spaces located in out of the way corners of shopping malls, have found new life as children's museums, art galleries, libraries and walk-in medical care centers.

Prior to the start of construction, the Asset Manager should review those factors which may affect the work schedule, such as materials availability, environmental issues or labor problems, and plan accordingly. The work itself should be phased so as minimize the potential impact on existing tenants, with unoccupied spaces, if any, slated first. The Asset Manager should not only provide supervision on a regular basis, but also keep tenants abreast of progress made, such as in periodic newsletters, telling them what to expect in terms of noise or disruptions (i.e. closed entrances or elevators).

The construction process can be as much a marketing tool as the end result contemplated. Press releases should be prepared for frequent distribution to the real estate community. At the commencement of construction, the Asset Manager should host a kick-off party for both current tenants as well as local brokers where the scope of the project can be dimensioned and renderings displayed. At the end of construction, another event should be planned capping off the project.

MANAGEMENT EFFICIENCIES

Beyond the prospects for revenue enhancement inherent in a well executed repositioning, several additional profit centers are available to the resourceful Asset Manager. These range from the installation of vending machines to rooftop antennae to opening up amenities, such as off-street parking and health clubs, to non-tenants. Other opportunities include charging for exterior signage rights and special services, renting out common areas for special events or using the property as a backdrop for television or movie shoots. Locating a property's third party leasing broker in an on-site office can also generate additional rental income. Also, by negotiating an early termination or buy-out of an existing tenant's below-market lease, the Asset Manager may be able to install a new tenant at a higher rate. However, it should be kept in mind that any attempt to merely raise rents in order to boost income may end up playing into the hands of competitors who will inevitably counter such moves with aggressive pricing of their own.

WHAT MAKES A GOOD ASSET MANAGER?

An Asset Manager is by definition a generalist, who must be able to marshal a broad spectrum of talents and resources on a daily basis. Academically, these include leasing, finance, marketing, property management, human resources, law and construction. Because of this diversity of expertise, it is important that the asset manager stay current with developments in these various disciplines. Beyond this, however, is a basic curiosity about the world around him/her and a knack for creative problem-solving. The Asset Manager must at once be a good communicator with tenants while being able to maintain the owner's interest at heart. People skills are therefore indispensable. For those who choose this career path, Asset Management can be a rewarding profession. ■

A LULU of a Case: Gauging Property Value Impacts in Rural Areas

BY P. BARTON DELACY, MAI, ASA, CRE

THE DAYS WHEN WELL-INTENDED CIVIC LEADERS could develop and build necessary infrastructure without some type of regulatory review are long gone. One person's irrigation project is another's nuclear waste dump. In undeveloped rural areas, it seems a road cannot be widened without triggering an Environmental Impact Statement ("EIS").

Measuring and commenting on environmental impacts has long been the domain of civil engineers and scientists. However, today, the siting of any such locally undesirable land use, sometimes referred to as a LULU, may require expert comment on potential property value impacts.

The LULU is one of those serendipitous acronyms destined to join the vocabulary for land use disputes. This lexicon already includes NIMBY ("Not in My Back Yard") and the lesser-known BANANA ("Build Absolutely Nothing Anywhere Near Anything").

In many respects the expert is simply being asked to apply a before and after valuation theory to affected properties. However, the scope of alleged impact can be vast while the body of relevant observable market transactions non-existent. This lack of market data is most acute in rural areas where environmental concerns about encroaching infrastructure are strongest.

A partial list of LULUs could include any of the following: prisons, landfills, aggregate mines, power plants, power transmission corridors (including structures), Superfund toxic waste clean-up sites.

The first thing an expert must do is identify the type of impact the LULU might create. A short list of generally undesirable externalities might include noise, traffic, air or water emissions, or simply the visual impact of a man-made structure into a pristine countryside. Yet another concern today could be the risk that a power plant or even a substation could attract terrorist activities.

Second, consider timing and duration. When will the siting occur? Is the impact a one-time event, perhaps confined to the construction activity, or will there be a sustained operation, continuing indefinitely?

Third, how broad will the effect be? Directly impacted properties may simply be acquired at market value from willing sellers or condemned outright through eminent domain. But what about nearby properties? How far can an effect be expected to extend?

Finally, is it appropriate to consider whether benefits or incidental amenities can offset a nuisance? A new prison may supply needed employment and accompanying economic development to a depressed rural community, yet

About the Author

P. Barton DeLacy, MAI, ASA, CRE is Director of dispute analysis and litigation support services in the Valuation Services Advisory Group for Cushman and Wakefield of Oregon. DeLacy has been an adjunct professor teaching land use planning at Marylhurst University and teaches real estate appraisal at the Business School at Portland State University. His consulting practice frequently works in alliance with related professionals seeking custom solutions for complex valuation engagements. Previously published in The Appraisal Journal and The Journal of the American Planning Association, DeLacy holds a Masters in Urban Planning from Portland State University and earned a Bachelor of Arts from Willamette University. Contact: barton_delacy@cushwake.com

does that benefit outweigh the perceived stigma and attendant risk associated with a penitentiary?

The criteria for approval in the EIS process, or similar land use forums, looks at impacts in the aggregate, as opposed to effects on specific properties. Without question impacts can vary from parcel to parcel. Yet at what point does personal preference or the peculiar characteristics of a given site constitute evidence of a general, rather than a specific adverse impact?

Case studies in urban areas have established that stigma, noise, and even toxic emissions do not influence property values much beyond a two-mile radius. Further, the impacts diminish significantly with distance from the LULU. The adverse impact of structures on rural vistas is similarly limited, and diminishes with distance. In the final analysis, experts can use these studies with the same care that they apply more localized market data. [1]

Much depends on the facts of the situation and good judgment from the fence line.

LITERATURE REVIEWED

Real estate appraisers, social scientists, environmental engineers and lawyers have long debated the question of measuring and evaluating the likelihood of negative property value impacts from adverse land uses or events. Often money damages are at issue if such diminution in value can be proven for a specific property, but what about in the aggregate?

The predominant activity stimulating academic and industry research over the past 30 years has been the emergence of large scale and public environmental cleanups. Much of the available literature deals with the consequences of discovery and clean up of Superfund sites. Once remediated, a second question regarding the prospects of recovery back to some pre-event equilibrium raises concerns of long-term "stigma." A follow-on question is whether such stigma is compensable as a consequential damage when government sanctions are involved.

Most of the studies focus on that most sensitive of real estate types, the single-family dwelling. Commercial properties can also be adversely affected by externalities but the nature of their investment value (i.e., passive rent collection) allows for capitalization of diminution affects through rent reductions and vacancy increases. The value of residential property is much more susceptible to consumer preferences. The implication of these studies on rural properties will be explored here.

The literature available for review is somewhat limited. Most of the literature has focused on the consequences and costs of cleaning up so-called "brownfields." There have been few studies addressing how a LULU can affect property value; urban or rural.

The case studies reviewed here include a University of Wisconsin paper measuring the impacts on suburban housing values from a coal burning power plant,[2] a report on housing values in the aftermath of the Three Mile Island nuclear power plant failure,[3] a series of studies on value and stigma impacts of a closed lead smelting plant in Dallas, Texas,[4] a study on the effects of wind turbine development on local property values[5] and a comprehensive analysis on effects of overhead transmission lines on property values.[6] The latter two cases do address rural property concerns, but without resolution.

These studies all relied on some form of statistical analysis using multiple regressions. The urban-area studies were able to construct hedonic models to predict outcomes.

A residential hedonic pricing model regresses a series of descriptive statistics regarding a population of observations. When data is available, this is clearly the preferred tool. For housing models, typical characteristics include house size, lot size, bathroom number, age, fireplaces, and distance from some node of value such as a downtown. The models are used to predict outcomes, testing variables for significance. Thus a researcher may take into account other variations in property characteristics in determining the impact of a LULU on property value.

The key to any reliable statistical model is a sufficiently large data pool, or population, to allow random sampling. In general, these studies have proven most effective in urban or suburban residential areas where a high number of transactions involving fairly homogeneous properties can be observed. Given a significant sample size, fairly conclusive outcomes can be predicted using this method.

Even in urban areas, statistical studies attempting to predict value impacts on residential properties lack consistency in model design and applications of uniform adjustments to the data.[7]

Sparsely populated rural areas are much more difficult to study because the population of transactions available for observation are so limited. More indirect methods must be used instead.[8]

While so-called "sensory cues" are key to impacts, (i. e. what can be seen, smelled or heard) the concept of stigma has much more to do with reputation and the intangible components of human desire that influence "marketability." Marketability is defined by appraisers as the state of being salable.[9] Thus anticipating the future impact of a LULU has as much to do with attendant publicity as with the event or source of contamination.

The breadth of the studies reviewed suggests that a continuum would be useful along which LULUs might be arrayed. At one end would be undisputed undesirable land uses, like a Superfund site, at the other end positive amenities like lake frontage or a panoramic view.

Overall, these studies provide little evidence that long-term stigma is widespread once sites are remediated and certified safe. Pursuing this continuum analogy, the infamous Love Canal site, once remediated and redeveloped, experienced resale prices only a net 10-15% below comparables in unaffected areas.[10]

BLOMQUIST—COAL BURNING PLANT CASE STUDY

The seminal modern study looking at how locally undesirable land uses might impact property value was the Glenn Blomquist report in Land Economics (1974). He studied the impact of the siting of a coal-burning power plant on the suburban Chicago town of Winnetka, Ill. The paper estimated the total impact of a "relatively small, clean power plant" which caused measurable damage over 2 miles away.[11]

The Winnetka Power Plant was located in a residential neighborhood with no other important disamenity sources located near it. The plant burned coal, had relatively small capacity at 26-megawatt (MW) capacity whereas most large plants at the time generated up to 300 MW. Other amenity factors in the area included Lake Michigan, the Chicago Loop and Northwestern Railway and the Chicago Central Business District (CBD). Other factors influencing value included social economic groups, parks, political boundaries and local commercial centers.

The study found that the power plant property value gradient was no longer a relevant influence at 11,500 feet or 2.18 miles (3.5 km). Further, the study found that property value was elastic with respect to distance, amounting to an increase in value of 0.9 percent for each 10% increase in distance. Thus, the negative impact on property value closest to the power plant would approach 10% of value compared with similar residential properties located outside an 11,500-foot radius from the power plant.

The findings are particularly helpful in setting an upper limit where value impacts may be said to extend. The power plant could be isolated as a sole disamenity and the surrounding neighborhood was predominantly single family residential. The Blomquist study recommended that policy makers site structures like coal-burning plants in areas of non-residential activity where negative value impacts will not be imposed on nearby homeowners.

THREE MILE ISLAND—NUCLEAR UPSET EVENT CASE STUDY

Twenty-five years ago (March 27, 1979) an accident at the Three Mile Island nuclear power plant near Harrisburg, Pa., generated great concern for the health, safety and welfare of nearby residents. While no actual meltdown occurred, attendant publicity and national media reporting raised concerns nationally about the safety of such plants. As a result there have been no new nuclear power plants constructed in many years, while other existing nuclear power plant projects have been closed, or mothballed.

Reduced residential property values in the Harrisburg area were alleged and the U.S. Nuclear Regulatory (NRC) together with Pennsylvania State University examined the effects of the accident on residential property values and sales within a 25-mile radius of the plant. Regression analysis was performed on 583 sales of single-family residences which sold between 1977-1979. The study looked at the effects before and after the event. This statistical data coupled with interviews of knowledgeable market participants found no measurable effects, positive or negative, from either the placement of the plant, or the event.[12]

It should be noted that the event did not create any short or long-term physical damage to property (compared with emissions from a lead smelter for instance) and there was no "cleanup" required following the event.

What was discovered was that for a 4- to 8-week period immediately following the event residential home sales fell off precipitously, but then returned to normal, or recovered to equilibrium once it was clear there was apparently no long-term adverse physical effects.

Perhaps taking into account the findings of Blomquist, Three Mile Island was sited in an area of relatively sparse population where property values were already lower than the average. Thus, the event did not trigger any long-term drop in value.[13] The study acknowledges that local residents were indeed concerned that their property values would drop following the incident and the adverse publicity. However, the study found that any effect Three Mile Island might have had was swamped by the impact of rising interest rates and the shortage of mortgage funds that affected real estate markets, nationally, in 1980-81.

MCCLUSKEY—DALLAS LEAD SMELTER CASE STUDY

For her doctoral dissertation, Jill McCluskey, now a Washington State University economics associate professor, together with University of California Berkeley's Professor. Gordon Rausser completed a series of articles relating to an extensive study they undertook at the RSR lead smelting plant site in Dallas. The studies were undertaken in 2000 looking at transactions from 1979-1996.

The smelter operated from 1934-1984 and emitted airborne lead which contaminated soil in surrounding areas. The U. S. Environmental Protection Agency (EPA) found health risks in 1981 and RSR agreed to remediate using standards considered protective of health at the time. Additional controls imposed by the City of Dallas and State of Texas, followed. In 1984 the site was sold to Murmur Corporation, who shut the smelter down. Although the site was ruled clean by the courts in 1986, the Center for Disease Control reported additional health hazards in 1991. In 1993 the site was placed on the Superfund National Priorities List. The RSR smelter was located 6 miles west of the Dallas Central Business District (CBD) and was surrounded by residential neighborhoods.

At issue was the cumulative impact of pollution, in this case soil contamination from lead air emissions over a fifty-year period. While the public may not have been aware of the danger for much of this period, everything changed once the EPA got involved and mandated a clean up. The clean up took five years before the area was pronounced clean. McCluskey and Rausser then studied how quickly the real estate market recovered and whether a stigma, associated with the smelter might have longer-term impacts.

Interestingly, the studies are careful to distinguish between actual damage to a property (such as presence of a contaminated substance that must be removed or remediated) and the mere perception of danger or risk. The latter they discovered can be magnified by media coverage. Publicity regarding the risks contributes to long-term property value diminution. One paper argues reasonable risk of contamination is not required for a nuisance claim if "community effects" caused by contamination are present.[14] Elsewhere McCluskey and Rausser express concern that compensation paid for perceived risk may distort real estate markets.[15]

Other studies[16] were noted which documented that the impact of the waste site on property values dissipates rapidly with distance. This study used a continuity price gradient for distance and found that the distance from the smelter was a positive factor affecting values, but that its sphere of influence was limited. A modeling function allowed the influence of the smelter to diminish with distance.

The findings of McCluskey and Rausser concluded that negative impacts could be measured up to 1.2 miles from the site and the diminution in value was up to 20% of property value in that radius. The diminution in value actually varied over intervals, approaching equilibrium, in the late 1980s after the site was pronounced clean, then spiking down again when the CDC raised more red flags about health issues.

In the years following the clean-up (1987-90) no sales were reported within one mile of the site even though no further danger could be documented, clearly an indication of stigma. Later, in the 1991-95 period, sales within the one-mile radius did occur, but at lower prices than similar properties located further away from the smelter.

An earlier publication of a study of the smelter impacts by Larry Dale,[17] found that each one-mile interval located beyond the site accounted for approximately 2% of the home price. The Dale study concluded that increased publicity did not cause property values to further decrease and that initiation of the clean up offset the publicity issue.

The Dallas smelter studies are important because they confirm that the adverse impact of a local undesirable land use (LULU), such as a lead smelter, is confined to a relatively limited sphere of influence. This sphere of influence is perhaps no more than two miles from the offending site. Further, the McCluskey study documents how stigma can persist even without demonstrable risks simply through continued bad publicity.

THE EFFECT OF WIND DEVELOPMENT ON LOCAL PROPERTY VALUES

Wind turbines, the tall elegant windmills of European design, have begun to punctuate skylines and rural vistas where natural wind energy can be found. In the Pacific Northwest a significant wind project is planned for Kittitas County near Ellensburg, Wash., about 90 miles southeast of Seattle. Installed capacity, nationwide, has grown at a compound rate of 26% since 1998. The turbines can be 60-100 meters high (200-330 feet, the height of a 10-12 story building).

Opponents, however, have questioned whether property values will be lowered when in view of the turbines. Systematic research was undertaken to establish whether there is any basis for the claims. The Renewable Energy Policy Project (REPP) (Sterzinger et al 2000) reviewed data on property sales in the vicinity of wind projects and used statistical analysis to determine whether and to what extent the visual presence of turbines has had influence on prices of properties which have been sold.[18]

The REPP report hypothesized that if wind development can reasonably be claimed to hurt property values, then review of sales data should show a negative effect on property values within view sheds of the projects. The study found no significant empirical support that property values were diminished in any of 10 test cases from around the country.

Viewsheds or visual impacts were defined as areas within 5 miles of a wind farm where the turbine clusters can be seen. The limitations of the study involved the siting of these wind projects in remote rural locations where numerous homogenous sales were unavailable, compared with the urban areas referenced above. The simple regression model cannot explain all influences on property values. The REPP study authors suggested that future studies might expand variables. Refinements might include consideration of relative distances.

A regression analysis used monthly average change in price for all aggregate sales in the defined viewshed areas and a control community unaffected by the view. Comparable communities were selected based on comparable demographics and discussions with local assessors and was admittedly subjective.

In the Ellensburg case, we did use paired sales before and after the siting was announced and found that appreciation rates appeared to keep pace with unaffected areas in the county. Specific properties were found with view impairments. However, the area was already impacted by overhead transmission lines and towers. The wind turbines are typically sited in power transmission corridors.

Visual impact cases may be a better type of indicator to track consumer reactions to undesirable land uses. Knowledge of invisible emission impacts is contingent on the perception, attendant publicity and appreciation of the science.

THE EFFECT OF OVERHEAD TRANSMISSION LINES ON PROPERTY VALUES

Overhead Transmission Lines have received the most scrutiny from the standpoint of their visual impact in rural areas. A 1992 study by Cynthia Kroll and Thomas Priestley concluded that fee appraisal offices have the longest history of evaluating line-of-sight impacts, but lack any in-depth statistical analysis to verify obtained results. Interviews and personal opinions can produce dramatically varying results (and do not have the finality of actual transaction data).[19]

Proposed overhead transmission line projects often raise concerns about their potential effects on property values. In general, there are two types of property value impacts that may be experienced by landowners affected by a new transmission line. The first is a potential economic impact associated with the amount paid by a utility for a Right of Way (ROW) easement. The second is the potential economic impact involving the future marketability of the property. Although somewhat interrelated, these two effects are discussed below.

Just compensation for a transmission line easement has been typically interpreted as the difference between the fair market price of the land with and without the encumbrance of the line. Economic impacts to landowners may occur if they are not compensated for the “highest and best use” of the affected parcel or if the effective “taking” is larger than the actual easement.

The presence of a transmission line may not affect some individuals' perceptions of a property's value at all. Some people tend to view transmission lines as necessary infrastructure on the landscape, similar to roads, water towers, or antennae.

In general, transmission line studies have found that agricultural values are likely to decrease if the transmission line towers are in a location that inhibits farm operations. But this is a direct impact which is frequently compensated and recognized as a taking.

Positive impacts may also occur, where the ROW is attractively landscaped open space and/or developed for recreational use.

The most sensitive rural properties were found to be those located in areas of recreational or second homes. Thus, more remote farming communities will be less impacted than those near recreation or scenic destinations.

Effects are most likely to occur to property crossed by or immediately next to the line, but some impacts have been measured at longer distances.

This overview on transmission lines suggests that the most serious impact is physical impairments of views for higher valued residences or vacation homes.

APPLICATION OF TRADITIONAL APPRAISAL METHODOLOGIES

Valuation is as much a subjective art as it is an empirical science. Every parcel of real estate is unique given that it is fixed in place, in finite supply, immobile, durable and of use to people.[20] The behavior of market participants is as determinative of price as physical attributes of the property.

Diminution in property value from some defect is typically measured on a cost-to-cure basis. When there is no demonstrable physical risk, such as direct contamination of a property, value can still be adversely affected by stigma and perceived risk.

Real estate appraisers have long recognized that outside factors, or externalities, can adversely affect property value as a form of depreciation referred to as economic or external obsolescence.[21] Economic obsolescence is incurable, at least in the short run. Analogous to external obsolescence is the concept of stigma, which might be termed in a real estate context as the failure of a property to recover its value once a defect is, in fact, cured.

Property value impacts created by an external incident or environmental factors can be measured through development of an hedonic model. For the model to function accurately, however, a data set must be established that is sufficiently large and homogeneous to isolate the impact influence within acceptable levels of variance.

Ideally there would be a body of data consisting of properties, which had recently sold in rural areas influenced by a cement plant to compare with another set of sales in otherwise similar areas without such influence. Further, these observations would involve otherwise similar properties so that the difference in transaction prices could be attributed to the influence, positive or negative, to the nearby location of the cement plant. The collection of these so-called "paired sales" might provide an appraiser sufficient information to derive a measure of diminution (or enhancement) attributable to the suspected influencing factor. However, it is clear that, in no time a list of distorting elements grows as the appraiser takes into account how different one property might be from another.

The paired sales technique is commonly used by appraisers to derive appreciation calculations. Sales and resales of properties are paired with any change in price attributable to passive appreciation (or depreciation). The appraiser must adjust for any changes to the property, over time, between the sales.

An hedonic model provides an alternative approach to recover the implicit value or diminution in value which an adverse LULU may cause. The hedonic regression of sale prices with a set of characteristic attributes, including one for distance from the LULU, can then be used to predict the probability of adverse impact that a similar LULU in the subject location might have. Simply put, the hedonic model applies a statistically rigorous process to the paired sales technique relied upon by real estate appraisers to explain price differences for varying features.

The hedonic model attempts to sample randomly from a large population of observations. The models work best in mature urban areas. The key is to hold as many variables constant as possible to better gauge what increment a fireplace or additional bedroom adds to house values. Alternatively, a control area may be selected with a similar population of properties but in an area considered unaffected by the particular nuisance or any others.

In the case of rural areas, such a model would require a significant sampling from a large homogenous population of comparable property sales in areas with similar LULUs. The lack of data poses the principle obstacle for appraisers or land-use consultants attempting to measure property impacts, either way.

First, it is likely the analysis will be restricted to residential sale data, since other property types have too much variability. However, residential property serves as the proverbial canary in the tunnel, in so far as dwellings are most sensitive to environmental impacts.

Second, any one or a combination of external factors can swamp the influence attributed to a particular LULU. These externalities include, but are not limited to: local employment opportunities, the costs and availability of mortgage funds or the presence of offsetting amenities (like a view or water frontage). For example, demand for homes on golf courses remains high even though there are risks from striking golf balls and noise from sprinkler systems.

On an aggregate level, if property values can be shown to be appreciating even where there is knowledge of some risk, or where some blight is readily apparent, then it is very difficult to argue property values have been diminished by that effect.

One solution is to collect aggregate data from local multiple listing sources or assessors offices and trend it over time. The average price of homes sold can be a fairly consistent indicator, if there is a sufficient number of at least 100 or so.

The consensus in the academic literature is that adverse impacts to property values from undesirable land uses are confined to a two-mile radius from a given source of concern. View sheds for 10-story windmill farms have been studied at a five-mile radius. Transmission line studies use similar distances. Virtually all of the studies involving any kind of quantitative analysis focus on urban residential properties.

Farmland, because of its expanse and relatively low unit values (compared to urban land) has seldom been found to be affected by structures or emissions, so long as no material damage can be shown. Transmission line studies suggest a small negative affect in rural areas, but these negative affects can be attributed to second home use rather agricultural utility.[22]

One example of a demonstrable negative affect created by airborne emissions was the plume of nuclear fallout created by the Chernobyl event (1986) in Russia which degraded and contaminated pasture land for many surrounding miles. Ash fall from the Mt. St. Helens eruption (1980) in the Pacific Northwest materially affected cropland where it accumulated.

However, studies have suggested that the mere perception of risk may create stigma or adversely affect property value in areas with urban populations. Mountain views, access and frontage on a stream or lake command premiums for rural or recreational residential use. Whereas residential property is sensitive to nuance, reputation and other intangibles, farmland is bought and sold based on its productivity and utility. Even demonstrable contamination or poisoning would not necessarily diminish property value if a satisfactory cleanup could be undertaken.[23]

Farmland loses value if it loses its water rights or if its soil turns fallow because nutrients have been exhausted. In some arid areas, farmland loses value when too much irrigation begins to cause salts to leach to the surface, poisoning the crops. Low valued farmland or rangeland is typically bought and sold as large tracts where residential use is incidental to the farming activity. The presence of transmission towers, windmills, power lines, or any other structure or use does not adversely affect value because the parcels are too large with too low a unit value to be sensitive to that type of influence.

SOME GUIDEPOSTS FOR EXPERTS

Real estate consultants, be they appraisers, brokers or even academics, will be asked to provide guidance to policy makers if not evidence in contested land use reviews. Each case must be carefully examined regarding property value impacts of LULUs. However, reference to macroeconomic indicators and urban case studies can help focus the debate.

First, property values seem resilient, particularly when there is sustained population growth. Second, the value of large parcels in agricultural use (multiple acreage) seem far more likely to be affected by production and transaction factors (like availability of water and the costs of mortgage financing) than indirect impacts from LULUs. Finally, property values in rural areas will be most affected by local employment and the presence of recreational opportunities. ■

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PARTIES INTERVIEWED

John Patrick Asay, MAI, Director of Lands and Permitting, Northwestern Energy, 40 E. Broadway, Butte, MT (406) 490-1862; pat.asay@northwestern.com
J. Phillip Cook, MAI, CRE, J. Phillip Cook and Associates, 5107 South 900 East, Suite 200, Salt Lake City, UT 84117, (801) 266-7300; pcook@jpc.biz.com
Joseph W. Dunford, MAI, 745 Fairway Dr., Pocatello, ID (208) 237-5077; joe@jwdunford.com;
Jill McCluskey, PhD, Associate Professor, School of Economic Sciences, Washington State University, Pullman, WA (509) 335-2835; mccluskey@wsu.edu
James Strathman, PhD, Director, Center for Urban Studies, College of Urban and Public Affairs, Portland State University, PO Box 751, Portland, OR (503) 725-4069; strathmanj@pdx.edu

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Have Redevelopment Agencies Gone Too Far Using the Power of Eminent Domain?

The Supreme Court May Soon Tell Us

BY SEAN O'CONNOR

FEW WOULD DISAGREE THAT REDEVELOPMENT—in its traditional context—can be beneficial to society. Redevelopment has been responsible for revitalizing blighted and dilapidated communities where the previous property owners were either unwilling or economically unable to improve the property on their own. But while few would deny the possible benefits of redevelopment, few would also disagree that redevelopment, with its attendant power of eminent domain, is subject to abuse. This is primarily because although the Fifth Amendment places a "public use" limitation on the power of eminent domain, the term "public use" is largely undefined and left to the determination of local governmental entities.

The result is inconsistent and contradictory case law across the country, leaving property owners, practitioners and developers in a state of confusion. The United States Supreme Court may provide some much-needed guidance in this regard, as on September 28, 2004, it agreed to hear the case of *Kelo v. City of New London*, a case involving redevelopment and the expansive use of the power of eminent domain. The Supreme Court is expected to determine whether the Constitution allows the government to use eminent domain to take property for the purpose of economic development. This case will also provide the Supreme Court with an opportunity to provide a workable definition of "public use" in the context of the Fifth Amendment.

TRADITIONAL REDEVELOPMENT AS A PUBLIC USE

The Fifth Amendment prohibits the "taking" of private property for anything other than "public use." In the redevelopment context, the Supreme Court has held that this "public use" limitation is satisfied when eminent domain is used to eliminate slum housing. *Berman v. Parker, 348 U.S. 26 (1954)*. The redevelopment act at issue in Berman allowed for private enterprise to redevelop properties once they were acquired by the government through eminent domain. Because private enterprise was involved, the property owners in Berman contended the "public use" requirement of the Fifth Amendment was not satisfied. But the Supreme Court concluded that because the taking was for the public purpose of clearing blighted areas, the means of redevelopment through private enterprise did not violate the public use clause of the Fifth Amendment.

About the Author

Sean P. O'Connor is a partner of Sheppard, Mullin, Richter & Hampton LLP where he specializes in eminent domain and real estate litigation. Based in the firm's Orange County office, Sean was counsel for the church in Cottonwood Christian Center v. The City of Cypress. Contact: SOConnor@sheppardmullin.com

Although Berman dealt with the exercise of eminent domain to redevelop a severely troubled area, Berman also spoke in terms of judicial deference toward legislative determinations of public use. Accordingly, many jurisdictions interpreted Berman to allow for a more expansive use of eminent domain in the redevelopment context.

THE MORE EXPANSIVE USE OF EMINENT DOMAIN IN REDEVELOPMENT

Following Berman, there are innumerable examples of the expansive use of eminent domain in the redevelopment context. For example, in 1981, the Michigan Supreme Court allowed the City of Detroit to take an entire neighborhood, complete with more than 1,000 residences, 600 businesses and numerous churches in order to give the property to General Motors for an auto plant. *Poletown Neighborhood Council v. City of Detroit, 304 NW.2d 455 (1981)*. In Poletown, General Motors had announced its intention to close a plant, thereby losing more than 6,000 jobs, but General Motors offered to build a new assembly complex in the city if a suitable site could be found. The City of Detroit used its power of eminent domain to acquire the necessary properties, but the property owners contended that the taking was not for a public use.

The Michigan Supreme Court concluded that the taking of a residential neighborhood, for the purpose of conveying that property to General Motors for construction of an assembly plant, was a public use under the state constitution because of the economic benefits of the jobs and tax revenue that would result from the plant's construction. The case had national implications, and stood for the broad proposition that, for the most part, courts would not interfere with the local government's determination of "public use." Poletown is considered by many to be the beginning of an era marked by government's willingness to expansively interpret "public use" to fit its own redevelopment needs. Ironically, however, the Michigan Supreme Court could be setting another trend in the opposite direction as, discussed below, it just overturned its Poletown decision.

The United States Supreme Court also assisted in the broad interpretation of "public use" with its decision in *Hawaii Housing Auth. v. Midkiff (1984) 467 U.S. 229*. In that case, the Hawaii State Legislature attempted to address economic problems caused by land ownership in the form oligopoly. In response to this, the legislature allowed for the condemnation of the affected lands. The United States Supreme Court concluded that the legislation was a constitutional exercise of Hawaii's police powers. But, the Court also stated in the same decision that, "a purely private taking could not withstand the scrutiny of the public use requirement; it would serve no legitimate purpose of government and would thus be void." Id. at p. 265. Nevertheless, Midkiff has been relied upon by states and local governments seeking broad definitions of public use.

The increasingly broad interpretation of public use led to the Connecticut Supreme Court's recent decision that is now under review by the United States Supreme Court. This case, *Kelo v. City of New London (2002) 843 A.2d 532*, demonstrates how far some local governments are willing to go to take property through the power of eminent domain. The redevelopment plan at issue in Kelo involved an area approximately 90 acres in size and included residential and commercial areas. Unlike most redevelopment cases, the redevelopment agency in Kelo did not claim that the subject area was blighted. Instead, in a 4-to-3 majority opinion, the Kelo court held that the public use clauses of the United States and state constitutions authorized the use of eminent domain for economic development that would supposedly increase tax revenue and improve the local economy. Accordingly, Kelo represents a substantial expansion of the traditional notion of redevelopment where governments used eminent domain powers to condemn—and then improve—blighted areas. Under a strained interpretation of public use, the Kelo court approved the use of eminent domain merely to improve an area.

But the United States Supreme Court's decision to take the Kelo case may signal concern by some justices that local governments have gone too far.

RECENT EXAMPLES OF REIGNING IN THE USE OF EMINENT DOMAIN FOR REDEVELOPMENT

Certainly not all—or many, for that matter—local governments have gone as far as did the redevelopment agency in Kelo. California, a state not known for its restraint in using the power of eminent domain, has had two recent decisions where courts are skeptical of granting deference to questionable legislative determinations of public use. In *99 Cents Only Stores v. Lancaster Redevelopment Agency (2001) 237 F.Supp.2d 1123*, the Court held the redevelopment agency's efforts were in violation of the "public use" limitation of the Fifth Amendment, as the efforts were directed toward a private rather than a public use. The case involved the use of eminent domain to acquire property occupied by an operating discount store so that the property could be transferred to Costco, another commercial user. The redevelopment agency argued that the taking was necessary to prevent "future blight." The Court found this argument to be too speculative, and found that the real reason for the redevelopment agency's willingness to exercise the power of eminent domain was to appease Costco.

A similar situation occurred in *Cottonwood Christian Center v. Cypress Redevelopment Agency (2002) 218 F. Supp. 2d 1203*. In Cottonwood, the City of Cypress attempted to take through eminent domain vacant property that the church had acquired with the intention of building a church campus. As part of the redevelopment project, the City of Cypress intended to transfer the church's property to Costco, the same commercial user at issue in 99 Cents Only Stores. The Court granted Cottonwood's request for an injunction, holding that the City's proposed condemnation violated the "public use" limitation of the Fifth Amendment. The Court in Cottonwood was also suspicious of the City's contention that the taking was necessary to eliminate blight in the redevelopment area. Instead, the Court found the City's determinations "pretextual" and done merely "to appease" anther private property owner (Costco).

Earlier this year, the Michigan Supreme Court reversed its Poletown decision in *County of Wayne v. Hathcock (2004) 471 Mich. 445*. Hathcock involved the condemnation of numerous properties to build a 1,300-acre business and technology park. The property owners challenged the taking on public use grounds. The government argued that under the reasoning of Poletown, the taking was a valid exercise of the power of eminent domain. Reversing the position it had taken 23 years earlier, the Michigan Supreme Court ruled that the government's power of eminent domain must be in the interest of bona fide "public use" rather than some ill-defined notion of "public purpose" or "public benefit." Hathcock called Poletown a "radical departure from fundamental constitutional principles." "We overrule Poletown," the Court wrote, "in order to vindicate our constitution, protect the peoples' property rights and preserve the legitimacy of the judicial branch as the expositor, not creator, of fundamental law."

THE NEED FOR GUIDANCE ON THE LIMITS OF EMINENT DOMAIN FOR REDEVELOPMENT

As shown above, the lack of an understandable definition of "public use" has led to contradictory decisions across the land. Even the leading treatise on eminent domain acknowledges that there are two competing definitions of the term "public use"—a "narrow" definition and a "broad" definition *(2A P. Nichols, Eminent Domain 3d Ed. Rev. 2003 § 7.02 [2]-[7], pp. 7-26 through 7-37*). This treatise further acknowledges that neither definition can explain all eminent domain public use holdings and that "further efforts at providing a precise definition of 'public use' are doomed to fail, and many courts have recognized this . . . ." Id. Section 7.02[7], p. 7-37. It is perhaps for this reason that many people believe that Kelo will be among the most closely watched cases of the United States Supreme Court's 2004-2005 term.

THE AUTHOR'S VIEW

The narrow question before the Supreme Court in Kelo is whether "economic development" (raising jobs and tax revenues) is constitutional under the "public use" limitation of the Fifth Amendment. While the Supreme Court may opt for the easy route of only answering this narrow question, it should use this opportunity to provide workable guidelines in the entire redevelopment context as to how it relates to the "public use" limitation.

Cases such as the Connecticut Supreme Court's decision in Kelo have seemingly replaced "public use" with a malleable concept of "public benefit." These are not the same, and the Connecticut Supreme Court's interpretation in this regard renders the public use limitation of the Fifth Amendment essentially meaningless. If merely raising jobs and tax revenue can pass constitutional muster, then governments will have carte blanche to take virtually any property, as virtually any property could be put to a more profitable use. The power of eminent domain—to take property against someone's will—is an awesome power, and with that power should come commensurate responsibility. "Economic development" alone should never be enough to satisfy the "public use" limitation of the Fifth Amendment.

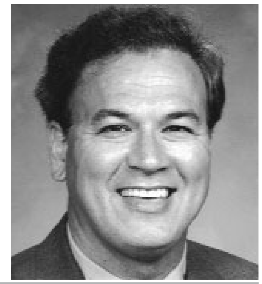
The Fifth Amendment very much belongs amidst the nine other amendments in the Bill of Rights where it is found. Its public use requirement upholds property rights and thereby ensures personal liberty. As the United States

Supreme Court has explained (*Lynch v. Household Finance Corp. (1972) 405 U.S. 538, 552*):

> "the dichotomy between personal liberties and property rights is a false one. Property does not have rights. People have rights. The right to enjoy property without unlawful deprivation . . . is in truth a 'personal' right . . . . In fact, a fundamental interdependence exists between the personal right to liberty and the personal right in property. Neither could have meaning without the other."

The public use requirement is, at its heart, a guarantee that individuals and their property will be treated equally under the law. Should the public use requirement serve as nothing more than a needless formality, inequality would surely result. Well connected persons, looked upon with favor by insiders to government, would become the sole governing criterion of whether or not one could own property. If the public use requirement were ignored, any citizen's property could be commandeered for someone's private enrichment. As a California court has held, "one man's land cannot be seized by the government and sold to another man merely in order that the purchaser may build upon it a better house or a house which better meets the government's idea of what is appropriate or well designed." *Redevelopment Agency v. Hayes (1954) 122 Cal.App.2d 777, 793*.

Indeed, it is for this reason that the federal and state constitutions allow condemnation only for "public use," not merely for better private use. And this is a critical distinction that the United States Supreme Court should recognize. The Court should not, in this author's view, allow the traditional notion of redevelopment to extend to "economic redevelopment," where a legislature, such as that in California, is free to come up with something called "economic blight." The Supreme Court can clarify matters by stating that "public use" is not the same as "public benefit." The former allows for the power of eminent domain to be invoked, the latter does not. The Supreme Court should define public use in the redevelopment context as it was contemplated at the time of Berman v. Parker, supra. Namely, the power of eminent domain should be constrained to the "traditional" redevelopment context, meaning to clear slum and truly dilapidated areas that are socially undesirable and create health risks. By limiting the use of eminent domain in this manner, the Supreme Court would preserve the relatively unobjectionable aspects of redevelopment, while at the same time give protection to property owners against over-zealous governments. ■



FOCUS ON INVESTMENT CONDITIONS

Searching for Clarity in An Uncertain World

BY KENNETH RIGGS, JR., CRE

IN LATE 2003 AND THROUGHOUT MUCH OF 2004, economic events finally began falling into place. GDP growth took off and has since settled down to a slower but steady rate. The Federal Reserve Board has been increasing the funds rate at a "measured" pace to normalize interest rates. Job growth continues, and the markets are improving. We've even seen commercial real estate vacancy rates begin to fall and rental rates inch upward.

While some of these events seem to solidify our investment outlook, other factors—both secular and cyclical changes—continue to impact real estate return expectations and leave us even more uncertain. Capital flows, which increasingly are being driven by demographics and the need for income-oriented returns, are affecting pricing. Outsourcing, logistics management, and other technological enhancements are continuing to increase productivity while reducing GDP in general and the demand for real estate. And consumers, who have sustained the economy through a recession, terrorist attacks, corporate scandals, and a war in Iraq, are expected to begin tightening their purse strings a bit as interest rates go up, inflation increases, and high oil prices eat away at their discretionary income.

WHAT DOES THIS MEAN FOR REAL ESTATE?

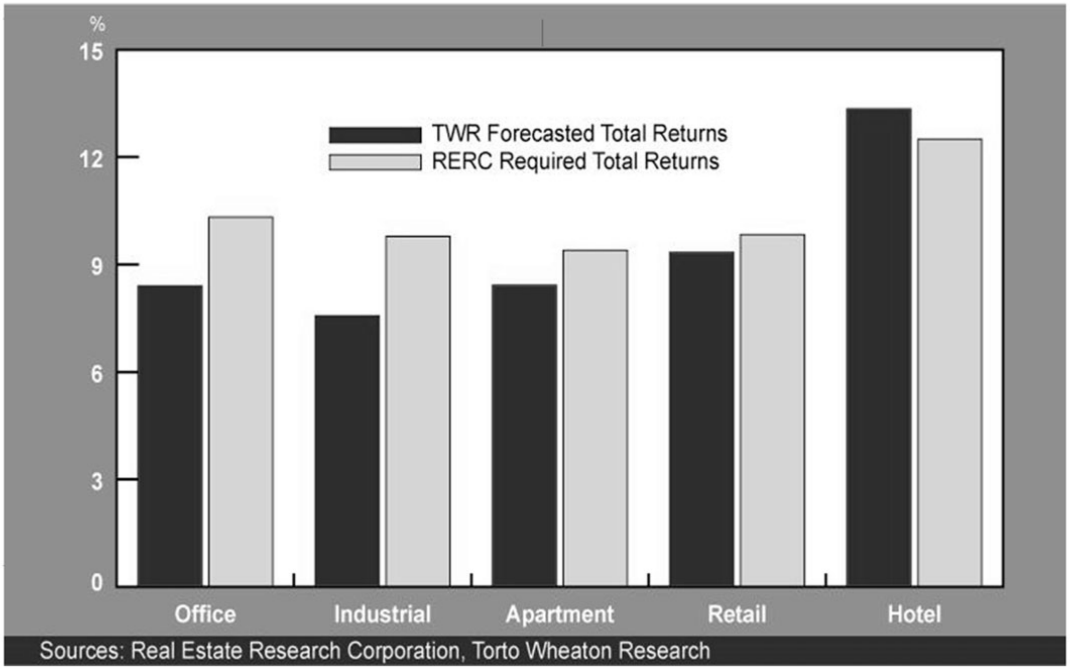
As noted in *Expectations & Market Realities in Real Estate: 2005—Navigating through the Winds of Change*, produced by Real Estate Research Corporation (RERC), Torto Wheaton Research, and Principal Real Estate Investors, a close examination of this uncertain environment, along with a realistic look at the return expectations for various property types, gives us a better idea of what investors can expect for returns. Real estate returns are certainly less volatile than those for many other investments, but there is no shortage of risk for any of the major property types. As noted in the following property discussion and in Figure 1, investors continue to require higher returns than those forecasted by Torto Wheaton Research. RERC believes the higher return expectations are due primarily to the uncertainties that remain in the market, which we believe will be resolved to some extent next year.

Demand fundamentals for the office sector are beginning to improve, and tenant credit quality is generally on the rise. However, job recovery and its effect on the office market will be uneven over the near term due to the economic health of various industries, businesses, and geographies. Prices and values continue to be driven up by the capital markets, despite weak occupancy and cash flows. RERC notes that although office continues to be one of the most volatile property types for the near term, longer-

About our Featured Columnist

Kenneth Riggs, Jr., CRE, FRICS, is chief executive officer of Real Estate Research Corporation (RERC). RERC offers research, valuation, independent fiduciary services, portfolio services, corporate advisory services, litigation support, and other real estate-related consulting services. RERC also provides research, analysis, and investment criteria (cap rates, yield rates, expense and growth expectations, recommendations, etc.) for nine property types on a national and regional level and for 40 major U.S. markets through the quarterly RERC Real Estate Report*, the annual* Expectations & Market Realities in Real Estate*, and the* RERC DataCenter.
(E-mail: riggs@rerc.com)

Figure 1—Forecasted Total Returns Vs. Required Total Returns



term prospects remain good due to population growth and the resulting demand for goods and services, which will spur business expansion and growth.

As the U.S. and global economy continues to grow and industrial-using employment improves, demand fundamentals for the industrial market are beginning to improve. However, increased logistic and distribution productivity and global trade will challenge demand for existing properties while increasing demand for larger, more efficient warehouse facilities in primary markets. In some secondary markets, however, there is a shortage of quality industrial space for smaller, niche users, and excellent redevelopment and repositioning opportunities exist in supply-constrained, in-fill locations. RERC believes that from a long-term perspective, the outlook for industrial space is quite favorable due to the continuing expansion of global trade and expected U.S. population growth.

Apartments continue to face pressure from continued high levels of new construction, but have generated strong total returns, as apartment capitalization rates have compressed to an all-time low. RERC's research indicates that demand is expected to continue to improve due to job growth, new growth in household formation, high housing prices, and increasing interest rates. Apartments have the ability to continue to generate strong absolute and risk-adjusted investment performance relative to other property types, but given current market prices and values, selectivity and pricing discipline are critical in optimizing performance.

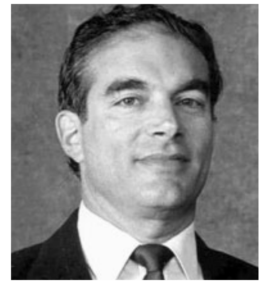
Although retail performance has been exceptional during the last couple years, RERC believes it is not sustainable due to a combination of factors including high pricing relative to reproduction costs, the bond-like nature of retail leases, the fact that capitalization rates cannot compress much further, and an expected slowdown in consumer spending during the next few years. Given this information, RERC projects that the retail sector will endure the greatest challenges in delivering acceptable returns over the next 5 to 10 years. Value opportunities continue to remain within this property sector, however, it will be much more difficult going forward and the winners will rise through active management. Despite our slightly bearish mid- to long-term outlook for this sector, retail centers in high population areas and especially those that offer elements of convenience are expected to perform quite well.

Although hotels have been trailing with respect to risk-adjusted returns, RERC notes that they have clearly started to rebound from the downturn that affected the travel industry after the terrorist attacks of September 11. Recent positive developments in the hotel sector are increasingly attracting investor capital. Given still relatively low prices and the strong income growth potential in this sector, RERC expects hotels to generate double-digit total returns in the years ahead.

We will all be a lot smarter in 2005, but until then, geopolitical clouds still prevail. Even so, the economy is still growing, and the election and the negativity associated with it are over. As events solidify, RERC expects:

- Economic growth to continue, with a 3.5- to 4.0-percent GDP growth rate during the next several years. But with projected productivity growth of 2.5 to 3 percent, employment will not reach its previous peak until 2005.
- Secular capital to continue to flow into real estate in 2005 due to real estate's income-oriented nature. This income, coupled with inflation-like growth, will continue to create a lower risk profile when compared to other asset classes.
- Real estate investment strategies to be part of a broader asset allocation mix. In an increasing interest rate environment, total returns on bonds will be affected more adversely than will real estate returns. With respect to the stock market, a combination of very low dividend rates (which suggests that most of the total return equation is dependent on upside) and still high P/E ratios (which suggests that additional upside will be a challenge) may cause stock market valuations to move in a sideways pattern for some time. Given this environment, some investors, especially those holding significant amounts of cash, will increase their allocations to real estate since the alternatives are somewhat unappealing, especially on a risk-adjusted basis.
- The hotel sector to draw significant amounts of capital, contributing to an increasingly competitive transaction environment. Given the strong income growth potential, we expect hotel prices to increase, allowing double-digit returns in the years ahead. The apartment and industrial sector will remain stable. With their high performance, we expect retail to undergo a re-pricing phase. The office sector in general presents the greatest risk.

Whether it is real estate, the stock and bond markets, or other alternatives, RERC reminds investors that sound risk management remains key to earning appropriate returns. ■



FOCUS ON THE ECONOMY

Globalization For All: Not If, But When?

BY DR. MARK LEE LEVINE, CRE, AND DR. LIBBI LEVINE SEGEV

IT DOES NOT TAKE AN INDIVIDUAL OF GREAT INTELLIGENCE to recognize the interaction and interplay of direct and indirect economic issues which are prevalent throughout the world. There are implications as to "globalization"—meaning the interaction of various countries with each other. Globalization is not a question of whether it will or will not happen; globalization exists; and it will continue. It is a question of the degree of the globalization or interaction and how individuals and businesses prepare for change generated by the interaction. The important issue is: What happens to a country if it does not "globalize" to a "reasonable" degree? The answer—in general—is that such country will be an "underdeveloped country."

Many actions in one country affect other countries, including fluctuations in stock markets, sales of properties, political revolutions, political unrest, religious issues, wars, shortages in goods and services, defaults on loans, struggles in economic political and social issues, and much more. The interplay that crosses borders is sometimes instantaneous, via the web or otherwise.

Noted later in this article are considerations of key facts that illustrate current interactions and dynamic implications of such positions for all countries, large and small, and, therefore, for all of the world population. A sneeze in one country may give a cold in another—or many other countries. Verbiage, such as "interaction," "interplay," and "globalization" cross international lines in economic, political and social discussions. They will become more commonplace in coming years. Individuals in each country must at some point recognize the absolute interaction of globalization and plan as best as one can for many variables that can and do impact individuals and countries.

A. KEY FACTORS OF INTERACTION/GLOBALIZATION

Having recently published a text entitled "International Real Estate: A Comparative Approach," Dearborn Publishing, Chicago, Illinois (2004), it is clear to me that there is a great deal of crossing of borders. A decision made in one jurisdiction or country can clearly impact the position of other countries. A template created in the above-noted text covers 14 key areas on various topics, e.g., Geography and History. Some of these areas are

About our Featured Columnists

Mark Lee Levine, CRE, PhD, is a professor and the director of the Burns School of Real Estate at the University of Denver. (E-mail: mlevine@du.edu)

Dr. Libbi Rose Levine Segev, JD, LLM, is an Adjunct Professor at the Burns School of Real Estate, Daniels College of Business, University of Denver.

noted below. An examination of these factors illustrates the areas in which globalization comes into play.

1. **Population**—This includes a mix of peoples involved, the distinction between males and females as to various matters, racial issues, birth rates, death rates, etc.

2. **Governmental—**This area includes issues of political systems (such as republics, democracies dictatorships, etc.), voting and control of governments, governmental structure of executive, legislative and/or judicial branches, where applicable, that influence decisions of each country and impact other countries.

3. **Economic—**This includes fiscal and monetary issues, valuation of currencies and fluctuations, debt positions, Gross Domestic Product (GDP), Gross National Product (GNP), per capita earnings, financial transactions, employment and unemployment, ability and training of citizens, production, etc.

Consideration of specific products, goods and services in each country is very important for balance of trade throughout the world. Identifying natural resources such as oil, natural gas, and other specific resources such as diamonds, will influence the economic position of each country and the ability to trade with other countries.

4. **Currency—**Means of exchange must be considered as part of the overall economic strength of each country, including devaluation of the currency, vitality of currency, and related issues.

5. **Transportation**—The ability for the people of a country to travel is important. It is also an important element to examine the movement of goods and services. This includes a review of the navigable waterways, overland transportation, air shipping, airports, pipe lines, etc.

6. **Communication—** The ability to communicate inside and outside each country is very important. It includes land phone connections, cellular phones, radio, television, internet, and much more.

7. **Cultural issues—**Cultural factors impact relationships between peoples and businesses. Knowledge of cultural matters is important to avoid social faux pas, including those when transacting business, communication at social gatherings, negotiating treaties between countries, discussing conflicts between countries, etc.

When looking to these and other key factors, it is helpful to review the web site, created at the Burns School of Real Estate and Constitution Management, Daniels College of Business at the University of Denver. This web site can be accessed without charge or passwords by accessing the web site at http://burns.dcb.du.edu

The following examples are some of the comparisons on this site:

Charts of comparison on:

a. Total area

b. Population

c. Life Expectancy

d. Literacy Rate

e. Inflation Rate

f. Unemployment Rate

B. COMPARISON OF FACTUAL DATA

Comparing data between various countries is important to transact international business. As an example, note the largest cities, based upon population, recently shown in the United Nations Population Division Research and also found in *The Economist*, *Pocket World In Figures* (2004 edition) published by Profile Books, Ltd., London, England (2003).

Those cities include Tokyo with 26.5 million people in the first position. Sao Paulo, Brazil has 18.3 million people. The 3rd position is held by Mexico City, with approximately 18.2 million people, although there are questions as to reliability of that number, along with other numbers reported by countries that may not necessarily keep verifiable statistics. (One reason for the poor statistics may be that poorer people tend to migrate into larger cities to take advantage of the potential of increased earning power in many of the cities.) The 4th position is held by New York City, with approximately 17 million people. Mumbai holds the 5th spot with 16.5 million people, followed by Los Angeles with a little over 13 million people.

Another important factual comparison deals with currencies. One example of a currency comparison between the U.S. dollar and other currencies is located on the web at the Currency Update Service under the Universal Currency Converter (http://www.xe.com/cus).

C. RISKS OF INTERNATIONAL BUSINESS

The Economist magazine (May 29, 2004) listed in an article the risks in dealing with emerging markets. In emerging markets, the article noted that the highest risk dealt with Iraq, which is no surprise, although the risk factor was reduced in 2004, as compared with May, 2003.

The next most risky emerging market, as noted in this article, is Argentina, followed by Angola, Venezuela, and then by Kenya. The country showing the least risk is Singapore. A slightly greater risk factor exists in Hong Kong.

D. COMMUNICATION

The ability to communicate is impacted by internationalization or globalization. An interesting study by International Telecommunicators Union (published December 2003), showed that less than 1% of the population of the world's poorest countries are connected on the Internet. Luxembourg has the highest percentage of its 450,000 residents who are connected to the Internet in relation to its smaller population. This is contrasted with a very small percentage of all of Africa's 760 million people that are connected to the internet.

E. GLOBAL COMPETITIVENESS

The Economist (May 29, 2004), noted global competitiveness rankings including the following:

First place was the U.S., followed by Finland, Singapore, Denmark, and Hong Kong. The Study refers to this as the "overall competitiveness position." However, when looking to competitiveness with the government facilitating support for competitiveness, first place belonged to Finland, followed by Singapore, Australia, Hong Kong, Luxembourg, and then the United States.

When looking to arrangements where countries combine their economic positions in trade blocs, Finland was in first place, followed by Luxembourg, Chile, Austria, Germany, France and Denmark. The United States was ranked 21st in this list.

There can be many other general comparisons made, but the above items illustrate the import of some areas where key factors, such as trade blocs, influence the position of countries and interactions between countries as to given measurements. Additional areas of interaction are noted below.

F. INTERACTION AMONG COUNTRIES

Representatives of governments in various countries make treaties or other agreements between nations. Recently the world has seen in economic settings additional treaties as well as trade arrangements that include NAFTA (North American Free Trade Agreement), GATT (General Agreement On Tariff and Trade) and the EU (European Union) positions, including conflicts and benefits recently in the news in EU countries.

The EU (European Union) has recently adopted a new Constitution. Additional countries have petitioned to enter the EU. The success or failure of the EU as to the goals first contemplated by early member countries of the EU remains in question.

Other trade agreements, economic agreements, governmental or political agreements, and many other agreements among countries have developed in recent years, e.g., the ECCU (Eastern Caribbean Currency Union), which consists of Antigua, and Barbuda, Dominica, Grenada, St. Kitts, and Nevis, St. Lucie and St. Vincent, as well as the Grenadines, along with two British Territories of Anguilla, and Montserrat. These countries work together with certain banking and currency arrangements. For more on this issue, see the publication of the National Association of REALTORS (NAR) "Expand Your Market—Think Globally, Act Locally," (2004).

Other arrangements or agreements among North America, Central America and South America include the Organization of American States (OAS). Asian countries also have blocs or agreements which are expanding to support positions of countries in attempting to work together and to empower their positions, as opposed to other competing nations.

Other agreements can impact countries where arrangements are not necessarily through governments. For example, in the real estate area, NAR has undertaken arrangements of cooperating associations within various countries. This is referred to as the International Consortium of Real Estate Associations (ICREA). This global alliance consists of various real estate organizations in numerous countries, some of which are impacted directly by governments within those countries, as well as those groups which are more independent from governmental controls.

Many other real estate and non-real estate associations or arrangements exist with economic agreements or coalitions which attempt to gain strength and synergy by combining power and positions of various countries.

G. IMPLICATIONS OF BUSINESS INTERACTION

Interaction of various business relationships between countries also impact governmental and private positions.

The ability to interact might include investing in other nations. For example, the Study by the Bureau of Economic Analysis, U.S. Department of Commerce (2002), indicated that the leading foreign country to invest in the United States was Japan, followed by Canada and the British Caribbean Islands, then by Germany and the Netherlands, and eventually by England. Some of this information is collected from the Bureau of Economic Analysis, U.S. Department of Commerce (2002), and is also illustrated in the earlier-mentioned NAR report "Expand Your Market—Think Globally, Act Locally."

Implications of foreign countries investing in various currencies are important. The U.S. dollar has been weakened in recent years, when compared to the Euro (EU currency) and the Japanese yen. The weaker position of the U.S. dollar (as compared with the EU Euro) results in more U.S. dollars required to purchase European goods. This also indicates a greater likelihood for more European countries and consumers to buy more U.S. goods (thereby potentially creating a U.S. trade "surplus"), as opposed to Europeans buying higher-priced similar Euro goods. It is also may increase foreign direct investment (FDI) in the U.S. However, *The Economist*, Sept. 25, 2004, noted that 2003 FDI "slumped by 53% to the lowest level since 1992."

H. OUTSOURCHING JOBS

The ability to outsource jobs and activities has been recently covered in the media. As an example, India currently uses the web and telecommunications to arguably produce the ability to price administrative work in India at a relatively lesser rate than for the same type of service performed in the United States. This produces interaction of economic positions with countries.

I. REAL ESTATE VALUATIONS

Another area of concern is home pricing in various countries and the implications of lower-priced or higher-priced homes. Obviously, lower-priced homes may encourage relocation of individuals and companies within various countries. Of course, other issues must also be weighed by the individual and company, including such concerns as political stability, economic conditions, ability to transport goods, education of the work force, cultural issues, etc.

As to housing prices, several articles in The Economist (June 5, 2004) addressed the issue of inflated housing prices in some countries and the concern with the potential "bursting bubble," or lowering prices of homes. One article (on page 11 of the June 5, 2004 issue) indicated substantial housing price increases in Spain, followed by Britain, Australia, the Netherlands, and then the U.S. A sudden "crash" or breaking of the "bubble" of various markets in a country could be very costly as to interactions between various countries and individuals, especially with overlapping trade and economic activities.

The article in *The Economist* (page 68, June 5, 2004), noted that Australia's housing bubble might be the first to break, but certainly not the last. Again, such an event would have important global implications.

J. NATURAL RESOURCES

Interaction among various countries has been in the news recently with regard to resources, such as oil and natural gas. Recently, the United States, especially, has felt the implications of oil shortages and the increasing prices, in excess of $50 per barrel of crude oil, which thereby increased gas prices at gas pumps for automobiles as well as costs to heat homes and buildings. In turn, this increases the interest in alternative fuel considerations. And, globalization issues abound.

K. CATASTROPHIC EVENTS

The September 11, 2001 tragedies in the United States gave rise to many implications throughout the world, including limitations on interactions between countries, limiting some forms of immigration in the U.S., etc. [After 2001, there was a decrease in immigration in the U.S. from certain Middle East and Asian countries, while there was an increase in immigration from Mexico. The Office of Economic Development study showed New Zealand increased approximately 1.5% in its total population of 4 million people in 2001.] Therefore, worldwide events, including terrorism or terrorism threats, impact interaction between or among countries, which also affects personal relations and business trade.

WHAT DOES THIS MEAN?

Countries and companies should review their positions and recognize that interaction through globalization is clearly here and will continue. The questions related to the rate of increase in change and how one is to forecast which areas will be impacted.

Such interaction can reverse, because of political or other issues. For example, Dell Computers undertook a great deal of activity outside the United States, especially in India. However, Dell reversed part of its position from undertaking some business with India. It pulled back to the United States in some job areas, such as outsourcing administrative work, arguably because of communication issues, difference in cultural points, political pressure, etc. Citing an AP News Agency, arguably, the reason for Dell's move in part was that "customers weren't satisfied with the level of support they were receiving," p. 58 *The Economist* (November 29, 2003).

Whatever the reasons for global change, it remains clear that globalization will continue. Important financial and cultural issues may not be adequately addressed when companies take steps to relocate activities and business ventures without first considering some of the issues noted herein, especially regarding communication, religious practices and cultural issues.

For more on these areas, see the text cited earlier, *International Real Estate*, Dearborn Publishing, Chicago, Illinois (2004). ■

FOCUS ON HOTELS AND HOSPITALITY

Are Floating-Rate Mortgages Best For Hotels?

Observations from the Recent Cyclical Peak-to-Trough

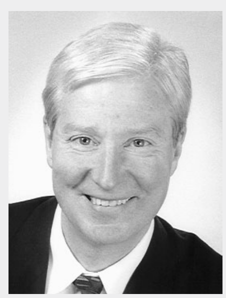
BY JOHN (JACK) B. CORGEL, PH.D AND SCOTT GIBSON, PH.D

INTRODUCTION

DURING JANUARY OF 2004, WE ATTENDED the American Lodging Investment Summit (ALIS), a large hotel industry investment conference held each year in Los Angeles. We sat through several sessions about financing hotel companies and properties at the conference. During literally every one of these sessions, fairly lengthy, and sometimes active, discussions erupted about the effective use of fixed-rate versus floating-rate debt for financing hotel investments. Our take away from the experience—floating-rate debt makes sense as a general proposition because hotels, unlike other commercial real estate, have pro-cyclical income streams unbridled by lease frictions that should resemble the time-series patterns of interest rates. However, we, like the panelists and other participants involved in these sessions, had views grounded in considerable ignorance because empirical work has never been done to confirm or refute the validity of financing strategies based on mixing fixed-rate and floating-rate mortgage debt.

As discussed below, one can quickly construct arguments that create reasonable doubt about the time-series relation between hotel revenues and debt-service obligations based on periodic movements of interest rates. Hence, certifying this relation is not obvious, but instead, should follow from a managed empirical exercise. During the past few months, we spent time assembling the necessary data to execute this empirical examination and help answer questions about how closely hotel RevPARs and interest rate series used in floating rate mortgage contracts behave over time.

This article reports on some of the findings from our larger study. Specifically, we carved out the past five years as an especially relevant period because hotel revenues rapidly went from their highest peak ever in 1999 and 2000 to a very deep trough in 2002 and 2003. These revenue

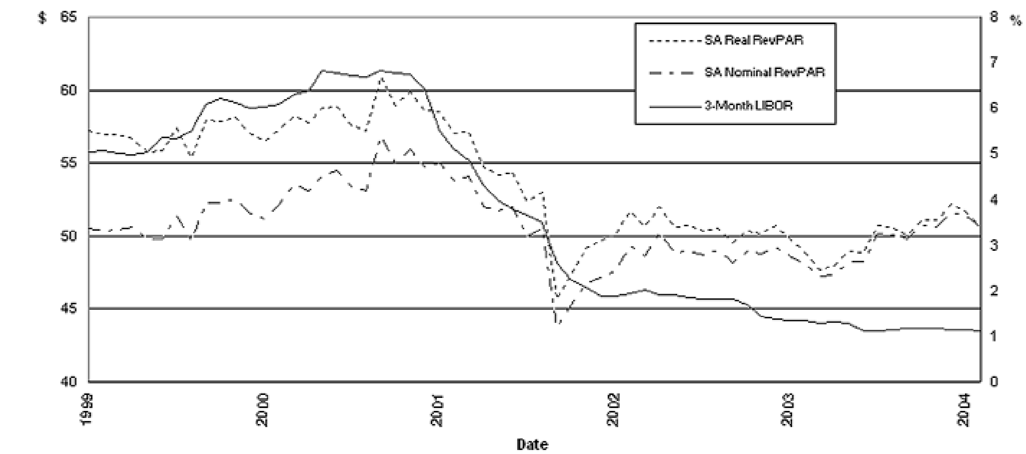


About our Featured Columnists

John "Jack" B. Corgel, Ph.D., (left) joined the Hospitality Research Group (HRG) of PKF Consulting in 1999 as managing director of applied research. There, he is developing new products for the hotel industry based on property-level financial performance information. Prior to joining HRG, he was a member of the Cornell Hotel School faculty for 10 years and served as the first director of the Center for Hospitality Research from 1992-1994. He is widely published in academic and professional journals and is a fellow of the Homer Hoyt Institute. (E-mail: jc1616@pkfc.com)

Scott Gibson, Ph.D., (right) is assistant professor of Finance, Accounting, and Real Estate at the Cornell University School of Hotel Administration. (E-mail:gsg23@cornell.edu)

Exhibit 1—Hotel RevPAR and LIBOR from Recent Peak to Trough



Sources: Smith Travel Research and Federal Reserve

declines imposed sizeable financial distress costs on hotel investors and lenders as evidenced by the large increase in hotel delinquencies experienced during this part of the cycle.

FINANCIAL DISTRESS COSTS

Under the assumption that debt markets are efficient, debt is fairly priced regardless of whether it carries a fixed rate or floating rate. Thus, in a world without market frictions, the fixed-rate versus floating-rate decision has neutral valuation implications. In the real world, however, market frictions exist. Of particular importance when considering the fixed-rate versus floating-rate decision are issues relevant to managing financial distress costs, such as those directly related to mortgage delinquency and default.

Given the potential for these costs to arise, fixed-rate versus floating-rate financing decisions take on significant valuation implications. To maximize value, the objective is to structure interest payments such that financial distress costs are minimized. This objective is accomplished by aligning interest payments, to the extent possible, with operating cash flows produced by financed assets. When hotel operating cash flows decline, as they did during 2001 through 2003 1H, it is desirous to have interest payment obligations coincidently decrease, thus mitigating financial distress.

SHOULD HOTEL REVENUES TRACK WITH INTEREST RATES?

Hotel properties represent a special category of commercial real estate because the users of spaces agree to short-term (possibly daily) tenancy, as compared to long-term (possibly twenty-year) leases. The volatility of revenues is a defining characteristic of hotels, a feature often cited by investors as the primary reason why hotel properties are viewed as riskier investments than other types of real estate. Yet for hotels and other property types, long-term, fixed-rate mortgages with constant debt service payments are the common means of financing.

Evaluations of the financial performance of hotel markets often begin with presumptions about the close relationships between macroeconomic fluctuations (i.e., the business cycle) and the sales of hotel room nights. The procyclical nature of the hotel business has substantial support from historical data. It is not shocking therefore to posit a connection between interest rates and hotel revenues even though connections between the real and financial sectors of the economy are seldom direct. As economic downturns and recoveries occur, the pattern of interest rate changes and the pattern of hotel purchases may not be synchronized because different sets of consumption behaviors affect travel decisions and decisions about borrowing and lending. The connection is further clouded by the fact that the determinants of average daily rates and occupancies come from the supply side of the market, which is governed by investment considerations, as well as the demand side. Thus, the underlying processes that drive the interest rate/RevPAR relation consists of a complicated set of consumption and investment influences.

METHOD AND DATA

The empirical analysis we performed involves a detailed examination of the time-series relation between short-term interest rate series commonly used to in hotel-debt finance (i.e., LIBOR) and RevPAR time series for all market segments and location subdivisions reported by Smith Travel Research (STR). In this article, we rely heavily on graphical presentations of the time-series and easy-to-understand statistical methods. All RevPAR data come from STR and, for this article, possess the characteristics described below.

1. Monthly observations from the beginning period of the STR time series, January 1999 (1999 M1) through February 2004 (2004 M2).

2. Aggregates hotel performance information for the U.S.; for each of STR's chain scales—luxury, upper upscale, upscale, midscale with food and beverage, midscale without food and beverage, economy, and independent; and for each of the STR location segments—urban, suburban, airport, highway, and resort.

3. Performance data during every month includes the number of properties, room revenue, number of rooms available, and number of rooms sold for each profile in (1) and (2) above. RevPARs come from dividing room revenue by rooms sold, then dividing rooms sold by rooms available, and then taking the product of these two results.

Due to the seasonal nature of the hotel business, we seasonally adjust RevPARs for this analysis. Also, due to the fact that inflation accumulates in ADRs over time, it is appropriate for time-series study to convert RevPARs from nominal to real terms. For completeness, we report results for both nominal and real RevPAR series.

Data on several short-term and long-term interest rate series were obtained from the Federal Reserve. Because hotel debt contracts normally include payment adjustment provisions based on short-term interest rate movements, only short-term interest rate series are used in this study. The analyses are performed with 3-month LIBOR, although several interest rate series were tested. All of the LIBOR series commonly found in hotel debt contracts, 1-month LIBOR, 3-month LIBOR, and 1-year LIBOR, move in close synchronization with one another, and statistically are highly correlated.

Exhibit 2

This table shows Pearson correlations coefficients for U.S. RevPAR, market segments RevPARs, and location segments RevPARs with 3-month LIBOR. All data are in levels. The RevPAR data are (1) nominal, seasonally adjusted and (2) seasonally adjusted and in real dollars. The market segments are: Luxury, Upper Upscale, Upscale, Midscale with Food and Beverage, Midscale without Food and Beverage, Economy, and Independent. The location segments are: Urban, Suburban, Airport, Highway, and Resort.

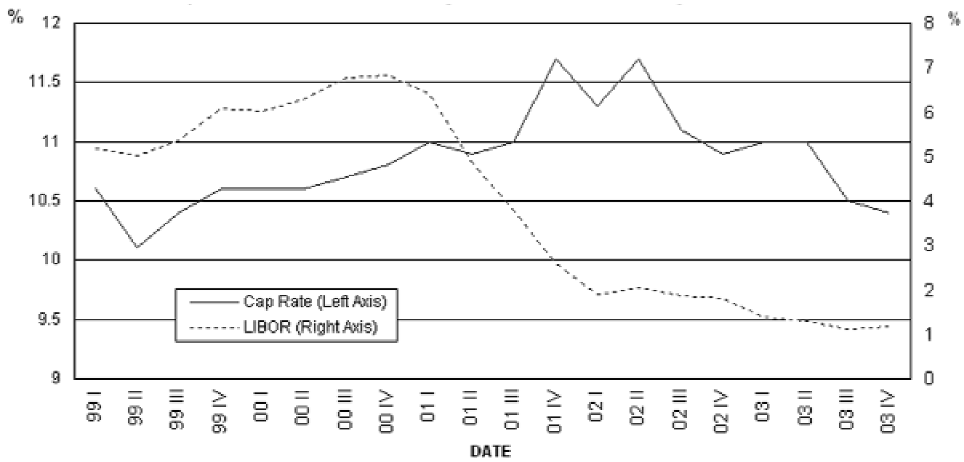
	Pearson Coefficient	
Hotel Segment	Real	Nominal
RUS	.79*	.57*
RLUX	.73*	.60*
RUU	.78*	.65*
RUP	.89*	.78*
RMFB	.90*	.78*
RMID	.77*	.37**
RECO	.92*	.84*
RIND	.71*	.43*
RURB	.76*	.62*
RSUB	.85*	.66*
RAIR	.90*	.80*
RHW	.79*	.39**
RRES	.46**	.18

* Significant at .01

** Significant at .05

Sources: Smith Travel Research and Federal Reserve

Exhibit 3



Sources: Federal Reserve and Real Estate Research Corporation

RESULTS FROM RECENT PEAK TO TROUGH

Exhibit 1 presents a graphical view of hotel room revenue (RevPAR) and LIBOR movements from 1999 M1 through 2004 M2. Two measures of RevPAR appear in the exhibit—nominal, seasonally adjusted and real, seasonally adjusted. The co-movements in LIBOR and the RevPAR series are remarkably close until early 2002 when RevPAR began to recover from the trough while LIBOR continued to decline. From the perspective of financial distress costs, investors who selected floating-rate relative to fixed-rate contracts benefited significantly since 2001. For those investors, debt obligations declined coincidently with revenue declines and lag revenue recovery.

The correlations in Exhibit 2 indicate close statistical relations between LIBOR and all but one RevPAR series during the recent peak-to-trough in the hotel market cycle. The correlations are for data covering the fall from the peak in 2001 M1 through 2004 M2. These relations are uniformly strong when the accumulating effect of inflation on room rates is removed. The correlation coefficient between U.S. RevPAR and LIBOR during the period was a remarkable .79 in real terms and .57 nominal terms. In the single case of nominal resort RevPARs and LIBOR is the correlation coefficient not statistically significant. Resorts follow a different business model than other full-service hotels—one in which 50 percent of revenues come from non-room sales (i.e., RevPAR), such as food and beverage sales.

CONCLUSION: WHAT ABOUT VALUES AND LIBOR?

In a world of cash-flow borrowing and lending, the immediate concern of the parties is whether or not property cash flow will comfortably cover property debt-service obligations. The results presented above indicate that in a peak-to-trough business environment hotel borrowers minimize financial distress related to delinquency by utilizing generous amounts of floating-rate mortgage debt. From a mortgage default perspective, the major concern of lenders is what happens to the value of the hotel property collateral during a rollercoaster ride through the business cycle? Theory suggests that values will rise and fall along with cash flow. However, values will move in the opposite direction from cash flows when the effects of interest rate changes on capitalization rates dominate. Exhibit 3 shows how hotel capitalization rates and LIBOR behaved between early 1999 and late 2003. As the graph indicates, capitalization rates and LIBOR movements followed three different patterns.

1. From 1999 through the end of 2000, both series increased.

2. From 2001 through mid-2002, the capitalization rate was rising and LIBOR was falling.

3. From the second half of 2002 until the end of 2003, both series declined.

The most distressful period for hotel borrowers and lenders occurs when RevPARs experience a sudden and dramatic decline, as they did from 2001 through mid-2002. During these periods, it would be especially desirable if property values were rising due to declining interest rates. Rising property values then would serve as a hedge against financial distress costs related to delinquency. The recent experience, as shown in Exhibit 3, suggests that hotel capitalization rates are pro-cyclical except in the case when interest rates experience rapid changes. Countercyclicality in this instance may be due the sluggish nature of capitalization rates relative to short-term rates, such as LIBOR. The implication is that property values may fall along with RevPARs and LIBOR for some time during a cyclical downturn, which further amplifies the need for hotel owners to have floating-rate debt in place as a buffer to the shock of a peak-to-trough experience. ■

FOCUS ON GLOBAL ISSUES

Building Conservation

BY NICHOLAS BROOKE, FRICS

THE CONSERVATION OF PROPERTIES IN PRIVATE OWNERSHIP is a topic which frequently provokes both frustration and emotion as Government policies usually fail to address the complexities of the challenge.

In Hong Kong "architectural significance" is the only test under the law when considering legal protection for our old buildings no matter what unique, historical, social or cultural value may be attached to a particular property, group of properties or even a neighbourhood. This means that many of our more interesting buildings and neighbourhoods may simply disappear merely because there is no policy or process to facilitate their protection. Until recently many Hong Kong people would not have been unduly concerned as what is "new" is generally valued above what is "old," but now an appreciation is slowly growing that a city without any evidence of its heritage, in the form of old buildings and long established neighbourhoods, loses context and depth. The lack of a robust and coherent Government policy in this area is no excuse for allowing such buildings and neighbourhoods to be demolished without further thought—once they have gone, there is no going back and all we will be left with is an unbroken sea of concrete and glass.

About our Featured Columnist

***Nicholas Brooke, JP, BBS, FRICS, FHKIS, RPS**, is the global president of RICS (the Royal Institution of Chartered Surveyors).*
(E-mail: nicholas.brooke@ppservicesgroup.com)

One of the key issues is that many such buildings are in the hands of private owners and most people in Hong Kong consider that it is not equitable simply to designate the properties for conservation purposes without adequately compensating their owners for the loss of resale or redevelopment value, no matter how strongly the community may wish to preserve the buildings for future generations. At present there is no dedicated source of funding for the purchase or upkeep of buildings considered worthy of preservation, although there have been more frequent calls in recent years for this to be addressed and a growing acceptance that this is, and should be, a cost borne by the community as a whole.

In some countries, buildings and areas are "listed" as being of particular heritage value or historic interest and this listing imposes restrictions on what can and cannot be done by way of demolition, alteration, or future usage. The owner has little say in the listing process and is not compensated for any loss in value as he retains actual ownership, even though his control over the property has to some extent been compromised. However, the imposition of restrictions is recognised as having imposed an additional financial burden on the owner and grants are made available to assist with repairs and upkeep as these are frequently more expensive than in the case of modern buildings.

In other jurisdictions, it is the Government that takes the lead, setting aside funds to buy, maintain and manage buildings recommended for conservation by specialist statutory boards, such as the Antiquities Advisory Board in Hong Kong. Whilst this resolves most of the issues, it is an expensive option and one that, for example, the Hong Kong Government is understandably reluctant to assume, given the current state of its budget deficit.

How else could such funds be raised? A "heritage" lottery has been suggested, perhaps once a month or so, so that contributions are made on a voluntary basis but with the burden spread widely across the community at large. Similarly, the creation of a body akin to the National Trust in UK has been mooted, initially seeded by Government but thereafter funded by donations, bequests, etc., which would acquire, manage, and maintain the best of our remaining heritage assets.

Another suggestion has been the allocation of a percentage of revenues from land sales but this again is a direct subsidy from Government and as such may not be acceptable. A more innovative proposal is that vouchers could be issued by Government to the value of any diminution in value suffered by the owner due to a conservation order being placed on his building, i.e., effectively the value of any latent development potential which could no longer be realised due to the classification of the property. This voucher could then either be used to purchase or part-purchase another property to that value, i.e., the vouchers could be traded and would have a recognised financial value. Alternatively, legislation could be introduced under which transfer of an owner's development rights in a "listed" property could be made to another less significant site of the owner's choice.

Finally, the owners of buildings of historic or social significance could perhaps be persuaded to preserve them voluntarily if Government was more flexible in its attitude to adaptation and reuse-sensible interpretation of building regulations, or even the introduction of a special code together with more sympathetic internal layout requirements could go a long way to extending the economic life of many buildings.

Exchange of ideas as to best practice and workable solutions is urgently required and perhaps this is an area where the members of CRE and RICS might consider working together to produce a guide to options and alternatives. ■

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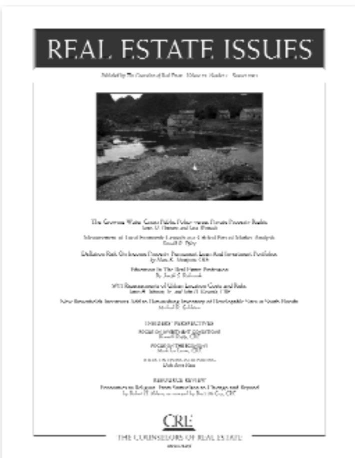

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